



Market Segment Specialization Program



# Furniture Manufacturing

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# Furniture Manufacturing

## Table of Contents

	<b>Page No.</b>
<b>Chapter 1, Introduction</b>	
Purpose and Nature of Information . . . . .	1-1
How the Study was Conducted . . . . .	1-1
The Furniture Industry in Southern California . . . . .	1-2
Characteristics of Furniture Manufacturers . . . . .	1-2
Upholstered Goods . . . . .	1-4
Wood Products - Custom . . . . .	1-4
Wood Products - Assembly Line . . . . .	1-4
Commercial Furniture . . . . .	1-4
Corporate Income Tax Issues . . . . .	1-4
How This Guide Is Presented . . . . .	1-5
<b>Chapter 2, Planning the Audit, Initial Interview, and Touring Facilities</b>	
Planning the Audit . . . . .	2-1
Identification of Potential Issues/Return Analysis . . . . .	2-1
Preparation of Information Document Requests . . . . .	2-3
Preliminary IDRS Research . . . . .	2-4
Speciality Referrals . . . . .	2-5
Initial Interview . . . . .	2-5
Tour of Facilities . . . . .	2-6
Fixed Assets Reported on Tax Return . . . . .	2-6
Match Production Responses to Visual Observations . . . . .	2-6
<b>Chapter 3, Required Filing Checks</b>	
Introduction . . . . .	3-1
Employment Taxes . . . . .	3-1
Employment Tax Reconciliation . . . . .	3-1

Employee vs. Independent Contractor . . . . .	3-2
Other Employment Tax Issues . . . . .	3-4
Other Considerations . . . . .	3-6
Information Returns . . . . .	3-8
Types of Information Returns . . . . .	3-8
Form 1099 . . . . .	3-9
Form 8300 . . . . .	3-11
Penalties . . . . .	3-12
Form 5471 . . . . .	3-15
Backup Withholding . . . . .	3-15
Assertion Procedures . . . . .	3-17
Abatement Procedures . . . . .	3-17
Related Returns . . . . .	3-18
Identifying Related Returns . . . . .	3-18
Corporate Taxpayer) Shareholder Issues . . . . .	3-19
Other Related Return Issues . . . . .	3-19

#### **Chapter 4, Balance Sheet**

Introduction . . . . .	4-1
Interrelationship Between Balance Sheet and Income Statement . . . . .	4-3
Effect of Balance Sheet Adjustments on Taxable Income . . . . .	4-3
Preliminary Audit Steps . . . . .	4-4
Reconcile the Book Accounts to the Return . . . . .	4-4
Comparative Analysis . . . . .	4-5
Auditing a Balance Sheet Account and Schedules M)1 and M)2 . . . . .	4-5
Cash . . . . .	4-6
Accounts Receivable . . . . .	4-9
Inventory . . . . .	4-14
Loans to/from Shareholders . . . . .	4-14
Building & Equipment . . . . .	4-18
Accounts Payable -- Other Current Liabilities and Other Liabilities . . . . .	4-20
Capital Stock/Capital Account . . . . .	4-23
Retained Earnings . . . . .	4-24
Schedule M)1 and Schedule M)2 . . . . .	4-24

#### **Chapter 5, Sales and Income Issues**

Introduction . . . . .	5-1
How Sales Are Generated . . . . .	5-1
General Audit Techniques . . . . .	5-2
Understanding the Sales Cycle . . . . .	5-2
Understanding the Accounting System/Internal Controls . . . . .	5-3

Specific Audit Techniques .....	5-3
Internal Revenue Manual 4231)582 .....	5-3
Other Recommended Income Probes .....	5-7
Other Income Issues .....	5-7
Unreported Interest Income .....	5-7
Bargain Purchases Under IRC Section 311(b) .....	5-8
Lease Inclusion Income: Passenger Automobiles .....	5-9
Contra)Sales Accounts .....	5-9
Returns .....	5-10
Allowances in General .....	5-10
Cash Discounts .....	5-10
Accounting for Returns, Allowances, and Discounts .....	5-10

## **Chapter 6, Cost of Goods Sold**

Introduction .....	6-1
General Audit Techniques .....	6-2
Understanding the Production Cycle .....	6-2
Understanding Integration of Accounting System .....	6-2
Comparative Analysis .....	6-3
Reconciliations .....	6-3
Specific Audit Techniques .....	6-4
Purchases .....	6-4
Cost of Labor .....	6-5
Other Costs and Deductions. ....	6-7
Inventories .....	6-7
Determine How the Inventory Amount Was Arrived .....	6-7
Determine All Possible Locations of Inventory .....	6-8
Obtain Ending Inventory Records .....	6-8
Journal Entry Analysis .....	6-8
Issues .....	6-9
Incorrect Inventory Accounts/Omissions .....	6-9
Improper Valuations .....	6-12
Uniform Capitalization Rules: IRC Section 263A or Tax Years Ending Before January 1, 1994 .....	6-15
All Direct Costs .....	6-15
All Indirect Costs Associated with Production .....	6-16
Cost Which are not Required to be Capitalized .....	6-17
Audit Techniques .....	6-18
IRC Section 263A Regulations: Post 1993 .....	6-25
LIFO Inventory Valuations .....	6-26

## Chapter 7, Change in Accounting Method

Introduction	7-1
What is a Change in Accounting Method?	7-1
IRC Section 481 Adjustment	7-2
How IRC Section 481 Interacts with an Inventory Adjustment	7-2
IRC Section 481(b)(1) and (2) Limitations	7-4

## Chapter 8, Maquiladoras

Introduction	8-1
Identification	8-2
Issues	8-3
U.S. Assets Used by the Maquiladora	8-3
IRC Section 482 - Allocation of Income and Deductions Among Taxpayers and IRC Section 1059A - Limitation on Taxpayer's Basis or Inventory Cost in Property Imported from Related Persons	8-3
Shelter Operations	8-5
Foreign Corporations )IRC Section 1504(d) Election	8-6

## Chapter 9, Expenses

Introduction	9-1
Advertising	9-1
Catalog Costs	9-1
Auto	9-2
Vehicle Owned by Corporation	9-2
Vehicle Owned by Shareholder	9-3
Vehicle Owned by Nonshareholder Employee	9-3
Leased Vehicles	9-4
Bad Debts	9-4
Determination of Worthlessness	9-4
Amount of Deduction	9-5
Examination Techniques	9-5
Capital Expenditures versus Currently Deductible Items	9-6
Examination Techniques	9-7
Pollution Control Permits	9-8
Commissions	9-9
Depreciation	9-9
Revenue Procedure 87)56	9-10

Listed Property .....	9-10
Examination Techniques .....	9-12
Dues and Subscriptions .....	9-12
Insurance .....	9-13
Life Insurance .....	9-13
Other Issues .....	9-14
Legal and Professional .....	9-15
Examination Techniques .....	9-15
Pension Plans .....	9-16
Examination Techniques .....	9-16
Rent .....	9-16
Examination Techniques .....	9-17
State Income Tax .....	9-20
Taxes and Licenses .....	9-20
Examination Techniques .....	9-21
Travel and Entertainment .....	9-21
Deduction Limitation .....	9-21
Recordkeeping Requirements .....	9-22
Examination Techniques .....	9-23
<b>Glossary .....</b>	<b>G-1</b>

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## **Chapter 1**

### **INTRODUCTION**

#### **PURPOSE AND NATURE OF INFORMATION**

Since the Los Angeles District began its audit specialization program, the goal has always been to provide examination employees (both field and office audit) with information on industries so audits could be performed in an efficient, effective, and intelligent manner. The purpose of this guide is no less. It is hoped that any examiner, who opens a furniture manufacturer, can use this guide to achieve optimum results.

In the past, various guides have assumed that an examiner possessed a certain skill level regarding corporate audits. Balance sheet techniques may have been mentioned but not spelled out in detail. In this regard, this guide has taken a slightly different approach. Basic audit techniques are still used during this study, but for purposes of this guide, they are outlined in a step-by-step fashion and explained in detail. Basic audit steps such as reconciliations, comparatives, balance sheet analysis, and even the initial interview have been integrated in this guide so that hopefully, an examiner can read a training manual or the Internal Revenue Manual (IRM) and see how audit steps are implemented in the course of a furniture audit. Every attempt was made to include citations from the Internal Revenue Code, Treasury Regulations, Revenue Rulings and Procedures, and the IRM so the examiner could be assured of locating the basis of any conclusions drawn. Much of the information will be a basic review for many experienced examiners; however, there are a few specialty items that will help even them.

#### **HOW THE STUDY WAS CONDUCTED**

A team of Revenue Agents began a study of the furniture manufacturing industry in 1992. The returns examined were filed between 1989 and 1992. The study focused on corporations but included a few partnerships and sole proprietorships. The majority of the corporations examined were of average size, but some of the larger corporations were examined also.

All the examinations included in this study were conducted within the Los Angeles District and much of the text reflects this bias. State laws outside of California may be very different than the laws encountered during this study. Regulatory bodies such as the Southern California Air Quality Management District may not have an equivalent in other states. Union practices may also differ from state to state. If there

are any geographical differences which could influence the outcome of a tax issue, the examiner is urged to carefully research those differences.

## **THE FURNITURE INDUSTRY IN SOUTHERN CALIFORNIA**

The furniture manufacturing industry, within Southern California, has proven to be quite extensive. Although not having the larger furniture manufacturers which are located in the Midwest or Southeast regions of the United States, Southern California has a large range of various manufacturers. Research of the Business listings for C-Corporations, S-Corporations, and Partnerships have shown over 1200 entities involved with furniture manufacturing. Several of these companies have sales exceeding \$100 million in gross receipts.

The industry, however, suffered many setbacks during the 1989-1992 years. California seemed to suffer especially hard from the National recession during those years and is still trying to recover. In addition, worker's compensation laws, union demands, and air quality restrictions seemed to tighten up the economy even further. Add in certain disasters (such as the riots in Los Angeles where many of the manufacturers were located) and it is understood why owners are hoping for brighter days.

Despite the above factors, some companies were able to break even and in some cases even flourish. Some companies sought alternatives to the high cost of labor by going south of the border to Mexico. These arrangements became widely known as Maquiladoras. Other companies began searching and developing new lines which did not require the solvents and finishes which emitted so much of the pollutants in the air. With such ingenuity, the industry began showing a slight comeback within the last 2 years.

Furniture manufacturing companies displayed a wide range of experience and tradition. Some companies have been manufacturing furniture for over 75 years. These companies have included two or more generations of owners within the same family. All the companies included in this study were closely held corporations with only a few having more than 10 shareholders.

## **CHARACTERISTICS OF FURNITURE MANUFACTURERS**

Although there is no such thing as a "typical" furniture manufacturer, many of the manufacturers shared common and consistent characteristics. For example, most of the companies had their own production departments. Rarely was any work

sub-contracted out. Practically all of the milling, sawing, sanding, fabric cutting and sewing, assembly, and finishing was handled in-house. In some instances, the lumber mills would pre-cut the wood to a manufacturers specifications leaving only the assembly and finishing.

Another shared characteristic seemed to be a heavy reliance on an independent sales force to represent them across the country. In only a few cases did a company have an in-house sales staff of more than seven sales personnel. However, many of the companies maintained their own showrooms either in Los Angeles or San Francisco, California; Dallas, Texas; High Point, North Carolina; or some other high traffic city.

Another common characteristic, especially for companies that made wood products, were outside influences and regulatory bodies. All companies that used solvents to coat or finish their products were overseen by the South Coast Air Quality Management District (SCAQMD). Surprise inspections are not uncommon and fines can reach as much as \$25,000 per day for criminal violations. Record keeping is mandatory when purchasing oil-based solvents and even specialized spraying equipment is required by the SCAQMD.

An area that warrants mention with the SCAQMD involves the permits issued by the regulatory body. Because the permits are strictly controlled and cannot be easily obtained, a market has opened up. Present law currently prevents permits from being transferred from one location to another. Therefore, if a company wishes to increase their spraying allocation, they must purchase the permit of another company which has either moved or closed down. This has created a market and in some cases, blocks of permits have been purchased for over \$100,000. Because of SCAQMD changes, the present emission control system is presently undergoing a revaluation. Currently, there is a plan on the drawing board to establish a system whereby approved companies would be allocated a certain number of "credits" to be applied against their pollutant emissions. If a company has been efficient and not used all of their credits, they may sell them to another company that needs more credits. This plan would certainly mean another source of income for some companies of which examiners will need to be aware. Presently, the plan is scheduled to take effect sometime in late 1995 or 1996.

Another outside influence are labor unions. Guaranteed wage minimums, health insurance plans, vacation and sick leave plans, and retirement plans are all costs which some furniture manufacturers must account for in their budget.

During this study, several different types of manufacturers were encountered. Most fell in four primary categories. Specialty furniture such as patio furniture was not included in the study.

The primary categories include upholstered goods, wood products - custom, wood products - assembly line, and commercial furniture.

### **Upholstered Goods**

This includes sofas, loveseats, ottomans, sectionals, recliners, etc. These companies are regulated by the Bureau of Home Furnishings in that material used to upholster goods must meet certain fire retardant standards. These companies usually have a breakdown in labor as follows -- Wood ripping/sawing, material cutting and sewing, wood assembly, and upholstery department.

### **Wood Products - Custom**

These companies specialized in producing wood products such as chairs, tables, bedroom, cabinets, etc. to customer specification using higher grade woods such as oak, cherry, and mahogany. These companies usually have a higher profit margin but sell fewer products. These companies use many of the solvents and finishes regulated by the SCAQMD.

### **Wood Products - Assembly Line**

This covers a range of goods from dinette sets to computer desks. Some expensive wood may be used but in most cases plywood or pressboard using expensive looking veneers were used. Production departments included sawing/ripping, assembly, coating, and finishing.

### **Commercial Furniture**

Certain companies specialize in commercial furniture such as counter tops, shelving, specialized tables, cabinets for housing projects, and office bookcases. These manufacturers are distinguished from the above in that they are often required to bid on jobs and may account for income on a modified percentage of completion method.

## **CORPORATE INCOME TAX ISSUES**

Certain general issues were encountered on a regular basis and are listed below with an occurrence percentage based on the 28 cases adjusted and closed during the study. This listing is for informational purposes and should only be used as a supplemental tool for the examiner's normal pre-audit selection process.

<u>Issue</u>	<u>Description</u>	<u>Occurrence</u>	<u>Percentage</u>
Inventory	Includes omissions, write-downs, errors and IRC section 263A revaluations		54%
Capitalization/ Depreciation	Includes capitalization of repairs and maintenance, leasehold improvements adjustments to depreciable assets method or life		43%
Constructive Dividends	This includes various expenses disallowed due to conversion to constructive dividends. Range of expenses included life insurance, auto expenses, legal fees, rent expense, etc.		36%
Income	This includes changes in accounting methods, errors, omissions, improper cut)offs, and adjustments to contra-sales accounts such as returns and allowances		25%
Improper Accruals	Includes errors made at end of year in accruing expenses as well as certain expenses not meeting the All Events and Economic Performance Test		18%
Officers Life Insurance	Disallowance under IRC section 264		18%
T & E	Includes improper compliance with 20 percent limitation, gifts, and lack of substantiation under IRC section 274(d)		18%

It should be noted that other issues included thin capitalization, loans to shareholders, bad debt deductions, and many different types of expenses.

## **HOW THIS GUIDE IS PRESENTED**

This guide is set up to match the natural progression of an income tax audit for field examination. It begins with the planning stages of the audit and continues through the package audit, balance sheet, sales, cost of goods sold, and expenses. Specialty sections include Changes in Accounting Methods, Maquiladoras, and vocabulary.

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## Chapter 2

### PLANNING THE AUDIT, INITIAL INTERVIEW, AND TOURING FACILITIES

#### PLANNING THE AUDIT

The objective of pre-audit planning is for you, the examiner, to familiarize yourself with items on the tax return and to provide a solid foundation for the audit. The Audit Technique Handbook for Internal Revenue Agents (IRM 4231) can be consulted for pre-audit techniques. The pre-audit planning should include the following:

1. Identification of Potential Issues/Tax Return Analysis
2. Preparation of Information Document Requests
3. Preliminary IDRS Research
4. Specialty Referrals

#### Identification of Potential Issues/Tax Return Analysis

Every audit should begin with a thorough analysis of the tax return. By analyzing the return, you will familiarize yourself with the company and its individual characteristics. Knowledge of these characteristics allows you to adjust your initial document request, tailor your initial interview questions to prevent confusion, and determine where the focus of the audit should be and where not to waste time.

The following portions of the return should be included for consideration:

1. Examine the first page of the return. Items that would be of interest would include:
  - a. Pension, profit-sharing plan deductions. If there is a deduction, obtain a pension plan questionnaire, Form 4632-A. This also alerts you for the possibility of Pension Plan Returns.
  - b. Check the boxes in the upper left hand corner of the Form 1120. These boxes inform you if a consolidated return, personal holding corporation, or personal service corporation is being filed.
  - c. Check the line marked net operating loss deduction and special deductions. If there is an NOL deduction, check the return for any statements regarding the

year which generated the NOL. Once this is determined, transcripts can be requested to verify the loss year(s).

## 2. Schedule A - Cost of Goods Sold or Operations

Always note the methods used for valuing closing inventory. Specialty boxes checked such as LIFO inventory method may require pre-audit research of IRC section 472 or consultation with LIFO specialists. The initial document request may require modification to include the Form 970 (Application to Use LIFO Inventory Method) and the LIFO index work papers prepared by the taxpayer.

The Schedule A showing the computation of the cost of goods sold should be scanned for unusual figures. A company that has a zero inventory balance is highly unusual for a manufacturer.

## 3. Schedule E - Compensation of Officers

Note the officers and their respective salaries. If not previously included, a question about the officer's respective duties may be in order.

## 4. Additional Information

Read through the questions and the answers. Pertinent information regarding the business activity, ownership interests, and accounting methods may be obtained.

## 5. Schedule M-1

The pre-audit analysis of the tax return should include a scanning of the M-1 reconciliation. Note the items included on the M-1 but also note items not appearing. There are certain items that appear regularly on the M-1 of moderately size companies. For examples of M-1 items, refer to the balance sheet section of this guide.

## 6. Form 5471

The inclusion of the Form 5471, Information Return for Foreign Operations, with the tax return indicates the taxpayer owns a foreign corporation. With the furniture manufacturers this was usually a maquiladora.

## **Preparation of Information Document Requests**

Initial document requests and subsequent requests for documentation should be made using Form 4564. The form itself is self-explanatory, however, its use may vary with each examiner. On smaller cases, it may be more practical to request all items on a single request form, while on larger cases it may be more efficient to use a separate form for each account examined. In either case, Form 5699, Information Document Request Log, is a helpful tool in keeping track of request dates, information requested, and taxpayer response dates.

The examination can begin in the office by requesting the following items be mailed to you prior to the initial appointment. These documents would be helpful in familiarizing you with the accounts and directing you to specific areas of audit concern, such as:

1. Prior and subsequent year tax returns for a comparative analysis
2. Trial balance and adjusting journal entries
3. Related shareholder returns for compliance checks
4. Related corporate and partnership returns for compliance checks.

If the shareholder returns and related corporate/ partnership returns are made available before the first field appointment, analyze the returns and prepare initial interview questions regarding any "economic reality" issues. Questions may be raised, for example, if a shareholder shows no salary or wages on the Form 1040 return but manages to live in an affluent neighborhood.

After the initial interview and tour of the facilities, the focus usually turns towards the examination of the books and records so these items should be included on the initial document requests:

1. Company books and records, such as the general ledger, general journals, cash receipts, cash disbursements, sales, accounts receivable, and accounts payable journals.
2. Inventory
  - a. Physical inventory records
  - b. Schedules for the application of overhead for finished goods

- c. Valuation of inventory for lower of cost or market
  - d. IRC section 263A computation.
3. Employment tax returns, Forms 941, 940, W-2, W-4, and State DE-3.
  4. Information returns, Forms 1099 along with Annual Transmittal Form 1096 and Forms W-9 used to request payee identification numbers
  5. Commission and royalty schedules which were used to prepare the Forms 1099 issued.
  6. Fixed asset and depreciation schedules.
  7. Corporate minutes, corporate stock book, articles of incorporation and any amendments.
  8. Invoices and supporting schedules for the custom's duties, if Form 5471 is filed, or a deduction is claimed on the return.

### **Preliminary IDRS Research**

With the expansion of the IDRS system to include such recent transcripts as RTVUE, BRTVUE, PMFOL, IRPOL, etc., much more information can be obtained on taxpayers. It is suggested transcript requests be input well before the first appointment to ensure availability before the initial interview. The following are suggested but by no means all-inclusive:

1. MFTRA. Consider prior, current, and subsequent years for the corporate or partnership returns. To save time, you may also wish to request any employment tax transcripts for the year of audit. Having these available during the first few days of the audit may be useful if the employment tax returns are not provided. If the shareholders and their social security numbers are listed on the return, transcripts may be requested for the pertinent calendar years and stored away for future reference.
2. Information Return Transcripts. You have access to many different kinds of transcripts. These show information returns filed by the taxpayer or information returns filed for the taxpayer both in print form and On-Line. If these are desired, the IDRS and ADP handbook can be consulted along with the group secretary or manager.

If CBRS transcripts are requested, the group or POD representative should be contacted. If unable to secure a CBRS request, a Fraud Group may be able to assist you.

### **Specialty Referrals**

During this industry study, referrals were made to various specialty groups including fraud, engineering, and Employee Plans/Exempt Organizations (EP/EO). Careful consideration should be given in case of Form 1120, or Form 1065 returns, with assets in excess of \$10 million. If your case meets this criteria, a referral to the Computer Audit Specialist (CAS) group will be necessary. Since the CAS requires time to introduce himself or herself to the taxpayer and to familiarize himself or herself with the computer system, it is recommended you make a referral before the first appointment.

CAS personnel have been found very useful in terms of extracting information from the taxpayer's computer system and presenting it in a form that makes it easier to audit and interpret. Should it be warranted, a referral may be made on the ROWR Form 2500 and submitted through the group manager to the CAS Specialty groups.

### **INITIAL INTERVIEW**

The initial interview is important because it provides an opportunity to obtain valuable information which might not be available at later stages. At this time, you have the opportunity to explain the audit process and gain some background information on the taxpayer. There are some issues where the best developmental information comes at the beginning of the audit while the officer/shareholder is still candid and responsive (that is, accumulated earnings, reasonable compensation, etc.). At this time, also explain the use of the information document requests, set a time frame for receipt of responses, and discuss an overall time period for the examination.

It is also a good idea to have important correspondence initialed by the taxpayer or corporate officers at this time. Examples include the Notice of Beginning of Administrative Proceedings (NBAP) for TEFRA returns and the letter explaining the 8300 Currency Transaction Requirements.

See Exhibit 2-1 for questions that have been formulated to assist you with the initial interview. As with all pro-forma questionnaires, the questions listed cannot cover all the potential information to be gathered. This is left up to the ingenuity of the examiner. However, these questions may provide a solid start and foundation for future follow-up questions.

You are reminded that listening to the responses given by the taxpayers or

representative will provide opportunities to ask follow-up questions. This is important since the responses to the follow-up questions may result in identifying areas of audit concern.

In addition to asking the appropriate questions, you need to take the time to document responses received during the interview since they may be factors in determining whether to request assistance from a specialist or whether the assertion of penalties may be warranted. If possible, complete your notes as soon as possible after completion of the initial interview.

## **TOUR OF FACILITIES**

A tour of the facilities is helpful in understanding the business operations by providing a visual picture of the business. It gives you an opportunity to validate information received during the initial interview. If time is limited, it may be preferable to conduct the initial interview while touring the facilities.

During the tour, it will be important to observe the operation of the business and its facilities, keeping in mind the initial interview responses and any notes made while pre-auditing the return. The following items may be areas of concentration during the tour.

### **Fixed Assets Reported on Tax Return**

If fixed assets reported on the tax return are not found on the tour, inquiries as to their location or disposal should be made. Assets which appear to be not in use should not have any depreciation expense associated with it or should be fully depreciated.

### **Match Production Responses to Visual Observations**

It could be extremely helpful if you can see the processes the taxpayer has explained. Matching a visual process with verbal explanations can either raise further questions or clarify them.

A good interview and tour of the facilities solidifies the foundation of an examination by providing a visual understanding of the business, establishing a level of confidence about the information received, and identifying areas of audit concern not evident from the information on the tax return. While the items listed above are not all inclusive, they have been provided to assist you in the planning stages. Use your own investigative skills and judgment to acquire a better understanding of the business.

**QUESTIONS FOR INITIAL INTERVIEW**

**General Information and Compliance Questions**

1. Who prepares the corporate tax return?
2. Internal Control Questions - A list of questions can be obtained from the Internal Revenue Manual or various IRS training guides.
3. Were any relatives of the shareholders employed by the corporation? In what capacity? What were their duties?
4. Do any of the shareholders have any other dealings with the corporation? (such as lessor, vendor, consultant)
5. Do the shareholders own more than 10 percent of the stock in any other corporation or partnership interest? If so, does the corporation under audit have business dealings with these related entities?
6. What types of fringe benefits are provided to the employees such as life insurance coverage, medical or dental plan premiums, company vehicles, auto allowances?
7. Is the company dependent upon certain customers for their business? How does the company obtain new customers? What economic conditions, if any, have affected the business of the company?
8. At what point are accounts determined to be bad debts and what collection efforts are made?
9. Were any Forms 8300 filed? What kinds of cash transactions are made? For how much?
10. Are there any foreign bank accounts? Does the shareholder travel out of the country very often?

**Maquiladora Operation**

1. Who owns the foreign corporation?
2. Does the foreign corporation have a built in profit margin?
3. How is the price of goods sold to the domestic company set?
4. Does the taxpayer pay for any expenses on behalf of the maquiladora?

**Manufacturing Process**

1. What type of goods are manufactured? (upholstered goods, wood products, dinette sets, etc.)
2. What is the actual process?
  - a. Where are materials purchased from?
  - b. What are the labor processes?
  - c. Is there quality control or inspection?
3. Is there any scrap material?
4. Is any part of the manufacturing process done by subcontractors? If so, what part(s)?
5. Is production determined by customer order or is inventory maintained at a certain level?
6. Are any goods imported from overseas?
7. Is there more than one manufacturing facility? Is it offsite?
8. Is the taxpayer regulated by Air Quality Management District?

**Inventory**

1. Is the taxpayer on any special inventory method? (that is, standard costs, LIFO method, etc.)

2. Is a physical inventory taken? If so, by whom, and how is it valued?
3. Are any goods placed on consignment?
4. Does the taxpayer maintain an inventory of finished goods?
5. How large is the WIP (work-in-process) inventory?
6. What inventory records are maintained by the taxpayer?

**Showroom On/Off Premises**

1. If the taxpayer has a showroom on the premises, this may affect the uniform capitalization computation. If there is a showroom, (offsite, onsite), is there a significant finished goods inventory?
2. If there is an offsite showroom, how is it staffed? Are the workers employees or independent contractors?

**Uniform Capitalization**

1. How was the allocation for the IRC section 263A costs determined?
2. Number of employees in each department?
3. How much of each shareholder's time is allocated to production, sales, and administrative duties?
3. What is the square footage of the manufacturing departments in relation to the total square footage of the business premises?
4. What is the square footage of the administrative offices and marketing facilities?

**Sales**

1. How are sales generated? (independent sales staff, in-house sales staff, market shows, showrooms, etc.)

2. When are sales recognized and what kind of documentation is required to record the sale? (that is, delivery receipt, bill of lading)
3. Are deposits required at the time the order is placed?
4. Is full payment required before goods are delivered?
5. Are discounts a normal part of business? If so, what type of discounts are given? Are there any discounts automatically taken by certain preferred customers?

**Design/Advertising Expense**

What new products or designs have been introduced during the year under examination? Design costs as well as catalog costs for these items may require capitalization if useful life is greater than one year.

**Fines and Penalties**

Has the company ever been fined for violations by AQMD? Bureau of Home Furnishing? Contact third parties for verification of any violations.

## Chapter 3

### REQUIRED FILING CHECKS

#### **INTRODUCTION**

Required filing checks are mandatory. Refer to IRM section 4034. Although many of the required checks simply involve inspection of returns, you are encouraged to perform a few additional procedures. It is not unusual for the filing checks audit to produce the most tax dollars in a corporate audit, especially if employment taxes are involved. Other adjustments can flow from Form 1099 work, either through penalties or back-up withholding. Related return inspection often produces leads for follow-up, resulting in tax adjustments at either a shareholder, related partnership, or brother or sister corporate level.

In any case, take the time to verify that all returns within the taxpayer's realm of influence. This audit techniques guide only suggests a few steps covering the areas of adjustment found by team members. If you have a question regarding other areas (Excise, Estate & Gift, or Burned-Out Tax Shelters), it is recommended you review IRM section 4034.

#### **EMPLOYMENT TAXES**

In all examinations, particular attention should be focused on the employment tax area. The main concern is whether the taxpayer has improperly classified employees as independent contractors. If an improper classification was made and the issue is not raised, a future examiner may be precluded from raising the issue with respect to the same class of workers.

#### **Employment Tax Reconciliation**

A standard payroll reconciliation where you attempt to reconcile the wages and employment taxes between the employment tax returns (Forms 940/941 and Forms DE-3) and the income tax return can highlight many potential issues. Differences can arise when the wages per employment tax return are compared to the wages per income tax return. When differences do arise, an issue may be present.

1. Reconciliation Differences. When this reconciliation results in a difference, attempt to reconcile the difference. Reasons for a difference include, but are not limited to, the following:

- a. Amounts booked as salaries and wages but paid out of a general disbursement account rather than going through a payroll account. For example: Payments such as Christmas bonuses may get paid out of the general disbursements account rather than the payroll account and thus would not appear in the payroll journal.
- b. Officer salaries accrued through the shareholder loan account. In this case, as the amounts did not enter the payroll journal, the Form W-2 may be understated as it is generally based on the payroll journal. The shareholder loan account should be carefully scrutinized for this type of entry. These amounts are wages. Note that they may have been erroneously omitted from the wage amount shown on Form W-2. In that event, the shareholder probably failed to report the amounts as income on his or her personal income tax return, and an adjustment will have to be made with respect to his or her income tax. With respect to FICA and FUTA, it may be that the shareholder's wages have exceeded the wage base for FUTA and for the OASDI wage base for FICA. Note that the wage base on the HI portion of FICA was repealed beginning with calendar year 1994. Thus, the HI tax is payable on all wages beginning in 1994.

If, after examining the accounts for explanations of the difference, you are unable to complete the reconciliation, copy your work papers and give them to the taxpayer, along with a document request requesting an explanation, and appropriate documentation.

2. Reconciliation Example. To illustrate the reconciliation of employment tax returns to the income tax return, the reader is referred to Exhibit 3-1 at the end of this chapter. This exhibit discusses the mechanics of performing a reconciliation and provides an example.

### **Employee vs. Independent Contractor**

The following is a brief outline of the law regarding employment status and employment tax relief. It is important to note that either worker classification--independent contractor or employee--can be a valid and appropriate business choice. For an in-depth discussion, see the training materials on determining employment status. "Independent Contractor or Employee?" Training 3320-102 (Rev. 10-96) TPDS 84238I. The training materials are also available from the IRS Home Page (<http://www.irs.ustreas.gov>).

The first step in any case involving worker classification is to consider section 530. Section 530 of the Revenue Act of 1978 was enacted by Congress to provide relief to certain taxpayers who had acted in good faith in classifying their workers from the

potentially harsh retroactive tax liabilities resulting from IRS reclassification of independent contractors as employees. The statute is a relief provision and provides an alternative method by which to avoid employment tax liability where a taxpayer cannot establish his workers are or were independent contractors.

In order to qualify for section 530 relief, the business must meet consistency and reasonable basis tests. The consistency test requires that the business has filed all required Forms 1099 with respect to the worker for the period, on a basis consistent with treatment of the worker as not being an employee (reporting consistency); and that the business has treated all workers in similar positions the same (substantive consistency).

Under the reasonable basis test, the business must have had some reasonable basis for not treating the worker as an employee. There are three "safe harbors" that form the basis for an objective reasonable basis standard under section 530. These safe harbors are: (1) judicial precedent, published rulings, technical advice to the taxpayer or a letter ruling to the taxpayer; (2) a past favorable IRS audit on the same issue; and (3) long-standing, recognized practice of a significant segment of the industry in which the individual was engaged. A business that fails to meet any of these three safe havens may still be entitled to relief if it can demonstrate that it relied on some other reasonable basis for not treating a worker as an employee.

Before or at the beginning of any audit inquiry relating to employment status, an agent must provide the taxpayer with a written notice of the provisions of section 530. If the requirements of section 530 are met, a business may be entitled to relief from federal employment tax obligations. Section 530 terminates the business's, not the worker's employment tax liability and any interest or penalties attributable to the liability for employment taxes.

In general, the common law rules are applied in determining the employer-employee relationship. Internal Revenue Code section 3121 (d) (2). Nationwide Mutual Insurance Co. V. Darden, 503 U.S. 318 (1992).

Guides for determining a worker's employment status are found in three substantially similar sections of the Employment Tax Regulations; namely, sections 31.3121(d)-1, 31.3306(I)-1, and 31.3401(c)-1, relating to the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and federal income tax withholding, respectively.

In the examination of the furniture manufacturers, this issue arose with respect to salespersons for the company, especially those handling sales at offsite furniture marts. If the salesperson handles many different lines from different companies, he or she may likely be an independent contractor. However, if the salesperson handles only the

taxpayer's line, he or she will generally be an employee under the usual common law rules or, if not a common law employee, then a statutory employee under the Treas. Reg. section 3121(d)(3)(D) for FICA purposes. For further assistance regarding employment tax issues, contact the employment tax coordinator.

As early as possible during the examination, it is important to discuss with the taxpayer the reasons the workers were treated as independent contractors. During the discussion, keep notes of the taxpayer's responses. A taxpayer cannot have relied on court cases decided after the years in which the taxpayer decided to treat its workers as independent contractors. An opinion letter from an attorney written after the examination began is less persuasive than one that was written when the employer first began using the workers and treating them as independent contractors. The taxpayer has the burden of establishing industry practice based on objective criteria substantiated by the taxpayer.

### **Other Employment Tax Issues**

The discussion below addresses issues noted by team members during the examinations of furniture manufacturing returns.

1. Has the taxpayer included all compensation in the payroll computations and on the non-shareholder employees' Forms W-2?
  - a. In several cases, the taxpayers had failed to include bonuses and auto allowances in the non-shareholder employees' wages. In those cases, the employment tax returns were then adjusted to reflect the increase in wages and applicable employment taxes.
  - b. During the initial interview, question the taxpayer as to their policies on fringe benefits and bonuses. Have the taxpayer demonstrate how they account for these items and trace to the Forms W-2 of a sample of employees. Any discrepancy noted, should be discussed with the taxpayer and any appropriate adjustment made. In addition, if the employee in question is a shareholder, question the taxpayer as to any differences in shareholder employee versus non-shareholder employee treatment.
  - c. In one case examined, the corporate taxpayer was purchasing automobiles on behalf of several long time employees. These amounts had not been included in the employees' compensation. The employment tax returns and employees' income tax returns were adjusted to reflect the additional compensation.

2. Has the taxpayer issued both a Form W-2 and a Form 1099 to the same employee? Compare the Forms W-2 and 1099 to see if this has occurred. In several cases, the taxpayer issued a Form 1099 for bonuses and did not include the amount as compensation on the employment tax returns. The employment tax returns were then adjusted to include the bonus amounts as wages. Note: The employer may be entitled to relief for the withholding if the employees had reported the Form 1099 income and paid the appropriate taxes.
3. Does the taxpayer use an outside payroll service? Usage of a payroll service may tempt you into thinking there are no problems associated with a taxpayer's payroll. This is not the case since the payroll service only follows through on the information provided by the taxpayer. If the information is incorrect, the reports issued by the payroll service will be incorrect.
4. In the case of an S-Corporation taxpayer, has a shareholder-employee been paid a salary? In some cases, an S-Corporation reports compensation as a distribution rather than as a wage or salary in an attempt to avoid employment taxes for both the corporation and the shareholder. Rev. Rul. 74-44 was issued to direct a reclassification of a distribution to reasonable compensation and assert the related employment taxes. Rev Rul 74-44, 1974-1 C.B. 287.

**Example 1**

Assume an S-Corporation has a 100 percent shareholder who is also an employee and is single. The S-Corporation had ordinary income of \$400,000 to flow-through to the shareholder's individual return. The S-Corporation makes a cash distribution in the amount of \$300,000 in lieu of salary. Of this \$300,000, \$200,000 has been determined to be a reasonable salary for the shareholder-employee with the remaining \$100,000 accepted as a distribution. (Note: The income tax computations below take into account only the amount of tax related to the income from the S-Corporation without itemized deductions, exemptions, etc.)

If this were a December 31, 1993, tax return, the S-Corporation and its shareholder avoided the following employment taxes:

Employer's portion of OASDI:	6.2% of \$ 57,600 or \$3,571.20
Employer's portion of Medicare:	1.45% of 135,000 or 1,957.50
Employer's FUTA:	6.2% of 7,000 or 434.00
Employee's portion of OASDI:	6.2% of 57,600 or 3,571.20
Employee's portion of Medicare:	1.45% of 135,000 or 1,957.50
Total employment taxes avoided:	\$11,491.40

If the \$300,000 were handled as a distribution solely or as salary and a partial distribution, the income tax would be as follows:

1. Distribution of \$300,000. As was originally reported, the corporation had a flow through of ordinary income to the shareholder of \$400,000.

The shareholder would then pay income tax of \$139,172 on \$400,000 of ordinary income.

2. Reclassification of the \$300,000 distribution to salary of \$200,000 and distribution of \$100,000. The corporation would then have \$200,000 of adjusted ordinary income due to the \$200,000 salary deduction.

The shareholder would pay income tax of \$139,172 on \$400,000 made up of \$200,000 of adjusted ordinary income and \$200,000 in wages.

Thus, there is no difference in income tax to the shareholder, but the corporation and shareholder avoided employment taxes in the amount of \$11,491.40.

5. Did the taxpayer fail to withhold taxes from an employee's wages and then later pay those taxes? This is an unusual situation encountered by one team member. The corporation made payments to workers as independent contractors and, therefore, did not withhold any taxes. Later, during the year, the corporation changed their workers to employees. The corporation then made the payments to cover its regular FICA, FUTA, and SUI. In addition, it also paid the FICA, FIT withholding, and SIT withholding on behalf of the employees. Per Treas. Reg. section 31.3401(a)-1(b)(6), these taxes paid on behalf of the employee will be considered additional wages subject to additional employment taxes (FICA, FUTA, and FIT Withholding).

## **Other Considerations**

### **Questionable Form W-4 Program**

Review the Forms W-4 maintained by the taxpayer. Employers are required to submit a copy of an employee's Form W-4 if one of the following apply:

1. Employee claims more than 10 withholding allowances.
2. Employee claims exemption from withholding and earns \$200 or more per week.
3. The employer receives notification from the IRS telling the employer to withhold at a different rate.

If you note any of the above situations, the following steps must be taken:

1. Retain copies of the questionable Forms W-4.
2. Review each Form W-4 to insure the following information is included:
  - a. Employee name, address, and social security number.

- b. Employer name, address, and employer identification number.
- c. Date of the Form W-4.
3. Submit the Forms W-4 to the Service Center W-4 Coordinator through a Form 3210 transmittal.
4. Inform the taxpayer as to when a questionable Form W-4 should be submitted to the IRS. Advise the taxpayer the instructions for submitting Forms W-4 to the IRS are contained in Circular E and Treas. Reg. section 31.3402(f)(2)-1(g). The taxpayer should submit a copy of any questionable Form W-4 along with their Form 941 for the quarter following receipt of the Form W-4.

When the Forms W-4 are submitted, the Service Center will research the employee's filing history and determine whether the Form W-4 is correct. IRC section 6682 provides for a civil penalty of \$500 to be asserted against the employee for knowingly filing a false Form W-4. In addition, IRC section 7205 provides for a criminal penalty of \$1,000 to be asserted against an employee convicted of filing a fraudulent Form W-4.

There are no penalties asserted against the employer if they fail to submit the Forms W-4 as required. However, if the employer has received notification from the IRS to withhold at a different rate and he or she fails to do so, the employer is liable for the withholding taxes not withheld. In this case, the penalties associated with failure to withhold may be asserted.

### **Adjustments for Employment Taxes**

When you makes adjustments to the wages paid by an employer and assesses the additional associated employment taxes, the following report forms may be applicable:

1. Form 2504 Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment
2. Form 4666 Summary of Employment Tax Examination
3. Form 4667 Examination Changes-Federal Unemployment Tax
4. Form 4668 Employment Tax Examination Changes Report.

See IRM 4657 for detailed instructions on preparing the above report forms. In addition, note the taxpayer signs only the Form 2504. The other reports are signed only by you, the examiner, and copies provided to the taxpayer.

Whenever additional compensation and employment taxes are to be assessed, you are reminded to consider whether the appropriate limitations for the various types of taxes had been previously met. In many cases, the employee may have previously exceeded the \$7,000 limitation for FUTA tax purposes.

### **Interest Free Adjustments**

IRC section 6205(a) provides for an interest free adjustment for FICA and FIT taxes in certain situations. Per IRM 4641.1(3), an interest free adjustment may be appropriate when a taxpayer agrees to an adjustment by signing Form 2504. IRM 4641.1(2) states if the taxpayer makes full payment of the FICA and FIT taxes and penalties owed at the time of signing the Form 2504 agreement, interest will not be assessed. See Treas. Reg. section 31.6205-1.

If the interest free adjustment applies, make the following notation on Form 3198: Under special handling/processing instructions check the box noted "restricted interest case" and enter "Form 2285 not required, IRC section 6205(a)." See IRM 4677 for additional information.

If the taxpayer later notifies you they have been assessed additional amounts for interest, contact the Collections Liaison in the Service Center for assistance in having the interest abated. Collections Form 3870, Request for Adjustment, will be necessary and in the remarks section the following statement is necessary: "Interest is to be abated as the taxpayer made payment before notice and demand." The authority for this adjustment is Revenue Ruling 75-464.

## **INFORMATION RETURNS**

The examination of information returns can be an important part of any income tax examination. Failure to issue information returns or failure to include correct information may lead to various issues such as information return penalties, backup withholding, and unreported income.

### **Types of Information Returns**

There are numerous types of information returns a taxpayer may be required to file. The discussion below is limited to the types encountered by team members during the examinations of furniture manufacturing returns. Therefore, this section should not be considered a complete discussion of the filing requirements for all information returns one may encounter during an audit.

## **Form 1099**

The Forms 1099 encountered by team members included Form 1099-MISC for payments of non-employee compensation, rents and royalties, and Form 1099-INT for payments of interest.

In the case of non-employee compensation and rents, a Form 1099 is required to be issued to all individuals paid \$600 or more during a calendar year. In the case of royalties and bank deposit interest, a Form 1099 is required when payments aggregate \$10 or more during the calendar year. The Forms 1099 are to be issued to the recipient by January 31 and filed with the IRS by February 28 of the following year.

### **Examination Techniques**

1. Initial review of return. While reviewing the tax return, note expenses on the return that may indicate a requirement to issue a Form 1099. For example, interest expense may indicate a Form 1099-INT filing requirement, while commission expense may indicate a Form 1099-MISC filing requirement.
2. Initial IDR. The initial IDR should request all Forms 1099 issued along with the Form 1096 Annual Transmittal filed for the calendar year(s) encompassed by the tax year under examination. For example: The taxpayer's year-end is Form 9306. Request the Forms 1099 and 1096 for calendar years 1992 and 1993.

Reconcile the total number of Forms 1099 presented by the taxpayer to the number of forms issued per the Form 1096. If, for example, the taxpayer gives you 20 Forms 1099 and the Form 1096 indicates that 15 were filed, the taxpayer's credibility may be at issue. If a discrepancy is noted or if the Form 1096 is not provided, request a PMFOL from the group secretary. The PMFOL will give a summary of the information returns per the Form 1096 filed with the IRS. The PMFOL provides information from the Payer Master File in an on-line report.

3. Forms W-9. The initial IDR should also include a request for any Forms W-9 secured from independent contractors. The Forms W-9 are used to test the accuracy and completeness of the Forms 1099 issued. A comparison should be made between the Forms W-9 and the Forms 1099.

The Form 1099 must include both the payer's and payee's complete name, address, and Federal TIN. A sole proprietor must furnish his or her individual name and the Social Security Number or Employer Identification Number [See Treas. Reg. section 35a.3406-1).

If the Form 1099 contains incorrect information because the taxpayer relied upon the information provided on the Form W-9, it would generally be accepted the taxpayer has complied to the best of his or her ability. If, however, the taxpayer has not used the TIN provided by the payee, a penalty for filing an incorrect or incomplete Form 1099 should be considered, with possible intentional disregard of the rules. Additionally, if the taxpayer failed to obtain the payee's TIN, consider the application of backup withholding. See the Backup Withholding section of this chapter for further information.

4. Compare Form 1099 to Form W-2. Compare the Forms W-2 and 1099 issued. If there are individuals who were issued both a Form W-2 and Form 1099, review the employment tax section at the beginning of this chapter.
5. Verify Filed Forms 1099. The initial IDR should also request the taxpayer's schedules used to prepare the Forms 1099. Reconcile the amounts on the Forms 1099 to the taxpayer's schedule. If the taxpayer does not have a schedule, you may need to schedule out payments yourself to test the dollar accuracy. Select one or two Forms 1099 with the largest dollar amounts and reconcile the amounts on the taxpayer's schedule with the cash disbursements journal and canceled checks. The canceled checks should be compared with the cash disbursements journal and examined for any unusual endorsements. Any discrepancies should be questioned and if any such discrepancies are not adequately explained, the examination should be expanded to additional Forms 1099. Also scan the taxpayer's canceled checks as discussed in Chapter 4, Balance Sheet. As discussed below, there are penalties which should be asserted for filing incorrect Forms 1099. Note: The name per the cash disbursements journal and the Form 1099 may not match as checks may be issued to a business under the dba and the Form 1099 issued in the legal name.
6. Nonfiled Forms 1099. Also scan the cash disbursements journal for payments to individuals of \$600 or more for which a Form 1099 was not issued. In addition, while scanning the canceled checks (step 5), one should be alert for potential nonfiled Forms 1099. The taxpayer should be questioned as to the reasons why a Form 1099 was not filed.

If the taxpayer failed to file or furnish Forms 1099, consider the assertion of the penalties discussed below and the backup withholding provisions discussed later in this chapter on Backup Withholding.

You are reminded that Forms 1099 are generally not required to be issued to a corporation (Treas. Reg. section 1.6041-3(c)). If \$600 or more in payments are issued to an entity and the taxpayer states that no Form 1099 was issued because the entity was a corporation, consult any source available, such as

canceled checks, invoices, or correspondence, to verify this determination. If you are unable to verify the corporate status of the entity, it is the taxpayer's burden of proof to do so.

### **Form 8300**

If, in the course of such business, a taxpayer, engaged in a Trade or Business, receives more than \$10,000 in cash in one transaction or a series of related transactions, a Form 8300 is required to be filed. The Form 8300 is due to the IRS within 15 days of receipt of the reportable amount.

### **Cash**

Prior to February 3, 1992, cash was defined for purposes of Form 8300 transactions as coin and currency. For amounts received after February 2, 1992, cash includes cashier's checks, bank drafts, traveler's checks, or money orders with a face value of less than \$10,000 received in a designated reporting transaction or received in any transaction in which the recipient knows that these instruments are being used to avoid the cash reporting requirement. See IRC section 6721(2) and Treas. Reg. section 1.60501-1(c)(1)(ii).

### **RC-W Memorandum 42-56**

RC-W Memorandum 42-56 dated March 1, 1988, requires you to perform the following steps with respect to the Form 8300 requirements:

1. All business taxpayers must be notified in writing of the Form 8300 filing requirements. Exhibit 3-2, at the end of this chapter, is a sample of the Notification Letter.
2. The Currency and Banking Package Audit Check sheet must be completed, in duplicate, for all business taxpayers. The business taxpayers include those who file Form 1040 with Schedule C, Form 1065, and Form 1120. See Exhibit 3-3 at the end of this chapter for the package audit checksheet. Once the checksheet has been completed, retain a copy in your case file and give two copies to the group secretary to be sent for processing.

### **Examination Techniques**

1. Query CBRS System. Prior to the first scheduled appointment, the examiner should request a search of the Currency and Banking Retrieval System (CBRS). See Exhibit 3-4 at the end of this chapter for a sample request form. This form is given to the designated person in the group with access to the system.

2. Initial Interview. During the initial interview, the taxpayer should be:
  - a. Asked for details of any transactions noted from the CBRS query. In addition, even if the CBRS query showed no transactions, the taxpayer should be questioned regarding any large cash transactions.
  - b. Questioned about their awareness of the reporting requirements regarding cash receipts in excess of \$10,000. Establish if the taxpayer had knowledge before receipt of the Notification Letter discussed above. This may become important later in determining the appropriate penalty to be applied if any required forms were not filed.
2. Review Cash Receipts Journal. Review the taxpayer's cash receipts journal and deposit slips for cash deposited in excess of \$10,000. In addition, note cash deposits for \$5,000 or more. Remember, the reporting requirements include not only a single transaction in excess of \$10,000, but a series of related transactions totaling more than \$10,000.
3. Failure to File Form 8300. If the taxpayer failed to file the required Forms 8300, penalties as discussed below should be asserted.
4. Research. As large cash transactions were not encountered more than once during the examinations conducted by team members, the above steps are issue identification steps to be taken. If you encounter large numbers of cash transactions, further research should be completed. Refer to IRC section 6050I as a starting point for further research.

## **Penalties**

Information return penalties are governed by IRC sections 6721 and 6722. IRC section 6721 addresses the filing of the returns with the IRS and IRC section 6722 addresses the filing of the returns with the recipient.

The discussion of penalties below is limited to Forms 1099 filed under IRC section 6041, Forms W-2 filed under IRC section 6051 and Forms 8300 filed under IRC section 6050I.

If the failure (as defined below) to which either IRC sections 6721 or 6722 applies is due to reasonable cause and not willful neglect per IRC section 6724, the penalty will not be asserted.

**IRC Section 6721 - Failure to File Correct Information Returns.** The penalty provided for under IRC section 6721 is applicable in the following situations:

1. Failure to file an information return on or before the filing date
2. Failure to include all required information or the inclusion of incorrect information.

For information returns, required to be filed after December 31, 1989, there is a three-tiered structure based on whether the taxpayer corrects the failure within specified time periods as follows:

1. The taxpayer corrects the failure within 30 days after the filing date of the information return. In this case, the penalty is \$15 per failure limited to a maximum of \$75,000 for all such penalties imposed this calendar year.
2. The taxpayer corrects the failure by August 1 of the year. Then the information return is required to be filed. In this case, the penalty is \$30 per failure limited to a maximum of \$150,000 for all such penalties imposed this calendar year. This penalty is not available for failure to comply with IRC section 6050I; Treas. Reg. section 301.6721-1(b)(6).
3. The taxpayer does not correct the failure by August 1 of the year. Then the information return was required to be filed or within 30 days of the required filing date in the case of Internal Revenue Code section 6050I; Treas. Reg. section 301.6721-1(b)(6). The penalty is then \$50 per failure limited to a maximum of \$250,000 for all such penalties imposed this calendar year.

In the case of any person that has average annual gross receipts for the 3 most recent taxable years of less than \$5 million the annual aggregate limitations on the penalties is reduced to \$25,000, \$50,000, and \$100,000, respectively.

IRC section 6721(c) and Treas. Reg. section 301.6721-1(d) provides for an exception to the application of penalties on timely filed returns with incorrect information if:

1. Such failure is corrected on or before August 1 of the calendar year in which the required filing date occurs
2. The number of incorrect information returns on which the penalty may be waived for the calendar year shall not exceed the greater of:
  - a. 10 or
  - b. 1/2 of 1 percent of the total number of information returns required to be filed during the calendar year.

### **Example 2**

The taxpayer was required to file 200 information returns for 1992. The taxpayer timely filed the returns, but failed to include the payee's address on 50 of those filed. Therefore, the taxpayer has 50 failures to which the penalty may apply. The taxpayer corrects the 50 incomplete returns on July 5, 1993. The penalty will be waived on 10 of the information returns computed as follows: The greater of (a) 10 or (b)  $1 (.5\% \times 200)$ . Therefore, the penalty to be assessed is \$1,200 (40 failures at \$30 per failure). This special exception is not available for failure to comply with IRC section 6050I, Treas. Reg. section 301.6721-1(d)(4).

### **Intentional Disregard:**

With respect to the Forms 1099 and W-2, if the failures are due to intentional disregard of the filing requirements, the penalty is then the greater of (1) \$100 per failure or (2) 10 percent of the aggregate amount required to be reported correctly, with no limitation on the maximum amount of penalties that may be imposed for the calendar year. See IRC section 6721(e)(c)(a).

With respect to Forms 8300, if the failures described above are due to intentional disregard of the filing requirements, for amounts received after November 5, 1990, the penalty is the greater of (1) \$25,000 or (2) the amount of cash received in the transaction up to a maximum of \$100,000 per failure. In this case, there is no limitation penalties on the amounts that may be imposed for the calendar year.

### **IRC Section 6722 - Failure to Furnish Correct Payee Statements**

The penalty provided for under IRC section 6722 is applicable in the following situations for payee statements required to be provided to a recipient or a payer (in the case of IRC section 60501):

1. Failure to furnish a payee statement on or before the due date.
2. Failure to include all required information or inclusion of incorrect information.

The penalty is \$50 per failure limited to a maximum of \$100,000 for all such penalties that may be imposed for the calendar year.

### **Intentional Disregard:**

With respect to the Forms 1099 and 8300 discussed in this section and Forms W-2, if the failures described above are due to intentional disregard of the requirements to furnish a payee statement, the penalty is then the greater of (1) \$100 per failure or (2) 10 percent of the aggregate amount required to have been reported correctly. In this case, there is no limitation on the amount of penalties that may be imposed for the calendar year.

### **Penalty Assessment**

The assessment of information return penalties is done in conjunction with the key case with any time spent on the issue charged to the key case. A penalty file is to be prepared as follows and closed along with the key case to ESP for assessment:

1. Complete Form 3198 and attach to the outside of the file.
2. Complete Form 4318A explaining the issues and attach any workpapers used in working the issue. In addition, the case should be written up in IFRAC form.
3. Complete Form 8278 according to the instructions on the back of the form and place on top of the Form 4318A.
4. In an agreed case, the taxpayer signs Form 870. Place this on top of the Form 8278 in the file.
5. If the taxpayer does not agree to the assessment of the penalties, note on the Form 3198 the case is unagreed and the taxpayer wishes to appeal the assessment.

### **Form 5471**

If the taxpayer, under examination, owns a foreign corporation, the taxpayer may be required to file Form 5471 (Information Return with Respect to a Foreign Corporation) with the return. This form is a disclosure form and is to be filed by all parties who own a foreign corporation.

As for the furniture manufacturers, the only time this form was filed with the return was when they owned a maquiladora. If you determine a Form 5471 is required to be filed by the taxpayer, the assistance of an international examiner will be necessary. Chapter 8, Maquiladoras, will explain how to identify a maquiladora and how to make a referral for assistance from an international examiner.

### **BACKUP WITHHOLDING**

One of the major compliance tools to consider in the event Form 1099 statements were not filed when required or were filed but did not have a payee TIN is the backup withholding provisions of IRC section 3406. Backup withholding can be imposed in conjunction with the penalties under IRC sections 6721 and 6722.

If an individual is subject to backup withholding and amounts are not withheld, the payer becomes responsible and liable for the tax. For reportable payments made prior to January 1, 1994, the withholding rate was 20 percent. After December 31,

1993, the rate increased to 31 percent. As this rate is applied to the assessment, it can be substantial. The assessment, however, can be abated if the tax on the income was paid by the payee.

A payment is subject to backup withholding if the payment is subject to Information Reporting as set forth by IRC section 6041(a). For example, a payment for compensation to a non-employee from a trade or business aggregating \$600 or more for one calendar year is a reportable payment.

Application of IRC section 3406 to information returns required under IRC section 6041 involves two primary criteria. In the case of any reportable payment:

1. The payee fails to furnish his or her TIN to the payer in the manner required, or
2. The Secretary notifies the payer the TIN furnished by the payee is incorrect. Then the payer shall deduct and withhold from such payment, a tax equal to 20 percent (or 31 percent) of such payment.

The first step in determining whether backup withholding provisions are applicable lies in the required filing checks. All Forms 1099 should be secured as outlined in the Information Returns section above. Backup withholding may apply in the following situations:

1. A required Form 1099 was not filed, the TIN was not obtained, and backup withholding was deducted and deposited from the payment
2. The TIN was not obtained, backup withholding was not deducted and deposited, but a Form 1099 statement was filed
3. Forms 1099 were filed with incorrect TINs, and backup withholding was not deducted and deposited after notices were sent to the payer that the TIN furnished was incorrect.

To determine whether any of the above situations has occurred, inquiries must be made of the taxpayer as to what steps were taken to obtain a payee's TIN and what was the response regarding any such requests. Even though the taxpayer may not be subject to backup withholding, he or she may still be subject to the previously discussed information return penalties.

Note: If the taxpayer has filed a Form 1099 with a correct TIN, backup withholding would not be applicable even if the dollar amount of the Form 1099 is incorrect. In this situation, you would again have to look to the information return penalties in lieu of the backup withholding provisions.

## **Assertion Procedures**

Backup withholding is treated as an employment tax. Therefore, as with all employment taxes, the agreement report is Form 2504.

The report forms to be completed are Form 4666 and Form 4668. With respect to the Form 4668, Employment Tax Examination Changes Report, you must change item 4 to read as follows: "Payment subject to backup withholding IRC section 3406."

You will need to establish the proper return on AIMS as follows:

1. For periods prior to the first quarter of 1994 backup withholding under IRC section 3406 is asserted on the Forms 941 for the applicable quarters of payment similar to employment taxes. However, in some cases, it may be asserted in the last quarter of the calendar year.
2. Beginning with the first quarter of 1994, backup withholding is reported on Form 945, Annual Return of Withheld Federal Income Tax. The Form 945 is an annual return and is due by January 31 of the subsequent year. As this is a new form, the procedures for assessment for backup withholding are assumed to be as noted. It is unclear, at this point, as to the procedure to follow if the taxpayer has not filed the Form 945. If you run into this issue, you are advised to contact the employment tax coordinator for the proper procedures.

## **Abatement Procedures**

Procedures have been established to handle abatement requests. Once the issue has been raised, taxpayers will often request that the assessment simply not be made by the examiner if a TIN can be provided currently. It should be noted the IRM grants the power to forego the assessment (with concurrence from the manager) if the taxpayer can provide evidence to show the income was reported and the taxes due were paid. The burden is on the taxpayer to provide such proof. IRM section 4696.1 states that evidence would be a copy of the recipient's income tax return clearly identifying the reportable payment in question, which has been compared with a transcript on file.

If the taxpayer cannot provide such evidence currently, then he or she must go through the formal abatement procedures by filing Forms 4669 and 4670 with the appropriate Service Center. These forms should be mailed to the Service Center and not to the examiner.

## **RELATED RETURNS**

Keep in mind the inspection of related returns is required by the IRM. Do not forget the examination is of the taxpayer as a whole, not just one segment of the whole picture. By following this, you will be performing an "economic reality" audit of the taxpayer and all his or her related entities. You should then be able to determine whether the taxpayer has reported a realistic taxable income.

During the audits performed, the team members encountered many issues with the related entities. In some cases, the issues on the related returns resulted in larger deficiencies than the key case examination. The following will explain how you can identify related returns and some of the issues you may encounter.

### **Identifying Related Returns**

During the initial interview, question the taxpayer as to the existence of related returns. It is important these questions be specific enough so the taxpayer understands the question and you receive the information for which you are looking.

If the taxpayer is a corporation or partnership, some questions which should be asked include the following:

1. Is the taxpayer a shareholder in any other corporations or partner in any other partnerships? Does the company do business with these corporations or partnerships?
2. Do the shareholders or partners own stock in any other corporations or are they partners in any other partnerships? Is business conducted with these related corporations or partnerships?
3. Do any close family members own stock in any corporations or are partners in any partnerships? Does the company do business with these related corporations or partnerships?

In addition to the initial interview questions, review the chart of accounts for titles which indicate a related party. For example: Loan to Affiliate.

Review the endorsements of either all the canceled checks or a sample of canceled checks for the tax year. Are any of the checks made out to companies and endorsed by known related parties? Note: This check can be done in conjunction with the Form 1099 check discussed previously in the information returns section above.

In addition, also closely inspect the Schedule E and related schedules of the

shareholders' and partners' returns. These often show investments in related companies.

### **Corporate Taxpayer - Shareholder Issues**

The inspection of related returns includes those of the shareholders of the corporation. Compare the returns to see that related transactions are properly reported on both returns.

Many of the issues involved with a corporate shareholder relate to the shareholder loan accounts on the balance sheet. Refer to Chapter 4, Balance Sheet, for more information.

### **Other Related Return Issues**

Pay particular attention to all transactions between related parties as well as the isolated transactions of the related party. Specific types of issues encountered by team members are discussed below.

1. During the initial interview, inquire as to whether the corporation made any distributions or gifts to its shareholders in the year under examination. A distribution may consist of cash, securities, and any other property. (IRC section 317(a))
2. Determine whether any transactions between related parties are occurring and, if so, the nature of these transactions. Transactions may take many forms such as consulting agreements, leasing agreements, expense sharing agreements, and so on. Scrutinize these transactions and if possible compare them with transactions held with other independent third parties. Valuation referrals may need to be made to determine fair rental or market value.

For example, in one particular case, the primary corporate taxpayer was found to have engaged in business with a related corporation. The corporation was related by common shareholders. The transactions were analyzed from both sides and it was determined the transactions were made primarily for tax avoidance. Before the transaction, the primary corporation had a large taxable income while the related corporation had a loss. The primary corporation wrote out a check for a substantial amount of money to the related corporation and deducted it as a consulting fee. The related corporation picked up the money as income. This transaction resulted in the primary corporation reducing its taxable income while the related corporation still paid no tax.

3. Rental transactions between Corporation and Shareholder -- See the Rent section

in Chapter 9 of this guide.

4. Are shared costs being properly allocated between two or more entities? One team member encountered the situation in which the 100 percent owner of a C-Corporation was also the 100 percent owner of an S-Corporation, both of which were furniture manufacturers. The two corporations operated out of the same business location, with the C-Corporation paying all the operating expenses. At year end, an allocation was made between the two and the S-Corporation reimbursed the C-Corporation for its portion. However, during the examination it was determined expenses related strictly to the S-Corporation were allocated to the C-Corporation. This resulted in a reduction of the taxable income of the C-Corporation which would have been taxed at a higher rate than the S-Corporation flow through to the owner's return. An adjustment was made to properly allocate the expenses between the two entities.
5. Keep in mind there may be potential issues on shareholder returns unrelated to the corporation. For example, inspection of a related Form 1040 revealed the individual had reported \$95,000 in gambling winnings and had offset that amount by \$95,000 in gambling losses. The individual must be able to verify the amount claimed as a loss. Another example includes a shareholder's return being picked up for examination because of large passive activity losses being deducted on his Form 1040 Schedule C for horse racing activities.
6. Commissions paid to the shareholders in a closely-held corporation on sales generated should be scrutinized carefully. In one particular case, a corporation was paying the shareholder a 30 percent commission on generated gross sales while the independent sales staff were being paid between 4 percent and 7 percent. In essence, this was a method of drawing a dividend out of the corporation while still taking a deduction at the corporate level. If this situation is encountered, the following is suggested:
  - a. Obtain the sales invoices used to compute the sales commissions and note if there is anything unusual or special about the customers (that is, larger sales orders than usual, higher price merchandise ordered, etc.).
  - b. Compare the shareholder's commission percentage with the regular sales percentage and if different, ask the shareholder to explain why.

If there is no particular reason why the commission percentages are different, it is recommended you propose a constructive dividend issue in much the same way a reasonable compensation issue would be proposed under IRC section 162.

## **Employment Tax Reconciliation**

The simplest reconciliation is performed when an accrual basis taxpayer's fiscal year end coincides with an employment tax return quarter end. This is demonstrated in an example below.

Often, however, the taxpayer's fiscal year end will not coincide with a quarterly end date. For example: A taxpayer has a fiscal year-end of July 31, 1992. The employment tax returns encompassing the income tax year would then be September 30, 1991; December 31, 1991; March 31, 1992; June 30, 1992; and September 30, 1992. Take the following steps to gather the information required for the reconciliation.

1. Starting at the beginning of the fiscal year, schedule the salaries, wages, and payroll tax expense accounts per the payroll journal. Schedule the amounts paid from the beginning of the fiscal year to the nearest quarter end. In the example above, this includes the months of August 1991 and September 1991.
2. Extract the wages/salaries and taxes from the employment tax returns for the next three quarters.
3. At the beginning of the final quarter, schedule the salaries, wages, and payroll tax expense accounts per the payroll journal. Schedule the amounts paid from the beginning of the quarter to the end of the fiscal year. In the example above, this includes the month of July 1992.
4. The amounts obtained above can then be reconciled using a reconciliation similar to that shown in the example below to determine whether there are any differences between the employment tax returns and the income tax return.

**Note:** Prior to January 1, 1991, the FICA tax was a combined rate for both old-age, survivors, and disability insurance (OASDI) and hospital insurance (Medicare). The combined rate was applied against the employee's wage up to the applicable wage limitation for each calendar year. Beginning January 1, 1991, the OASDI and Medicare rates are applied against different wage limitations for each calendar year.

**Reconciliation Example:**

The taxpayer, Oak Corporation, is under examination for the fiscal year ended June 30, 1991.

Per the face of the Form 1120 and Sch.. A Cost of Goods Sold:

Officer's Compensation	\$1,763,830.00
Salaries & Wages	445,895.00
Payroll Taxes	48,333.00
Sch. A Cost of Labor	959,180.00
Sch. A Indirect Labor	285,146.00
Sch. A Payroll Taxes	109,862.00

Per Taxpayer's General Ledger:

Accrued Payroll @ 7/01/90	\$ 479,218.15
Accrued Payroll @ 6/30/91	1,645,285.48
Accrued Payroll Taxes @ 7/01/90	9,761.62
Accrued Payroll Taxes @ 6/30/91	19,552.62

Per Employment Tax Returns:

<u>940 &amp; 941</u>	<u>9/30/90</u>	<u>12/31/90</u>	<u>3/31/91</u>	<u>6/30/91</u>
Total Wages	\$734,919.38	\$469,237.68	\$398,043.02	\$560,783.43
Withholding	102,586.00	43,299.43	34,031.56	54,631.40
FICA Wages	381,842.42	398,958.85	398,043.02	495,660.47
Medicare Wages	N/A	N/A	398,043.02	560,783.43
FICA Tax	58,421.89	61,040.71	49,357.33	61,461.90
Medicare Tax	N/A	N/A	11,543.25	16,262.72
FUTA Wages		652,631.25		
FUTA Tax		5,221.05		
DE-3				
SUI Tax	1,578.25	1,431.67	5,631.51	4,685.83
State Training Tax	87.68	79.54	351.97	292.86

Reconciliation of the above amounts and associated examination adjustments are shown on the pages that follow.

**Exhibit 3-1 (3 of 5)**

TAXPAYER: Oak Corporation  
FORM NO: 1120  
YEAR: 9106

AGENT: I.R. Agent  
DATE: 08)01)93

Reconciliation of salaries and payroll taxes to return

INFORMATION FROM FORMS 941 & DE-3:

QUARTER ENDED	TOTAL WAGES	WITHHOLDING TAX	FICA TAX	MEDICARE TAX	DE-3 TAX
9/30/90	734,919	102,586	58,422		1,666
12/31/90	469,238	43,299	61,041		1,511
3/31/91	398,043	34,032	49,357	11,543	5,983
6/30/91	560,783	54,631	61,462	16,263	4,979
<b>TOTAL</b>	<b>2,162,983</b>	<b>234,548</b>	<b>230,282</b>	<b>27,806</b>	<b>14,139</b>

FUTA Return Information:

Year 12/31/90

FUTA TAXABLE WAGES	652,631
TIMES RATE	0.008
	-----
GROSS FEDERAL TAX	5,221
LESS STATE CREDIT	(0)
	-----
NET FEDERAL TAX	5,221
	=====

Reconciliation of Wages:

WAGES - COST OF SALES	959,180
INDIRECT WAGES - COST OF SALES	285,146
SALARIES - OFFICERS COMPENSATION	1,763,830
SALARIES & WAGES	445,895
	-----
TOTAL SALARIES PER RETURN	3,454,051
	-----
SALARIES PER 941'S	2,162,984
LESS: ACCRUED PAYROLL BEGINNING	( 479,218)
PLUS: ACCRUED PAYROLL ENDING	1,645,285
	-----
TOTAL PER BOOKS	3,329,051
	-----
WAGE DIFFERENCE	125,000
	=====

**Exhibit 3-1 (4 of 5)**

Reconciliation of Payroll Taxes:

PAYROLL TAXES	48,333
PAYROLL TAXES-SCH. A	109,862
	-----
TOTAL PAYROLL TAXES PER RETURN	158,195
	-----
EMPLOYER FICA TAX (230,282 x ½)	115,141
EMPLOYER MEDICARE TAX (27,806 x ½)	13,903
EMPLOYER DE-3 TAX	14,139
NET FUTA TAX	5,221
LESS: ACCRUED PAYROLL TAXES BEGINNING	(9,762)
PLUS: ACCRUED PAYROLL TAXES ENDING	19,553
	-----
TOTAL PER BOOKS	158,195
	-----
PAYROLL TAXES DIFFERENCE	0
	=====

In this example, Oak Corporation has deducted \$125,000 in wages on the income tax return which do not appear on the employment tax returns. Upon further investigation, the examiner determined the following:

1. Per the general ledger, Officers' Compensation, Account Number 5010, included the following entries:

<u>Date</u>	<u>Reference</u>	<u>Amount</u>
7/31/90	Payroll Journal	\$170,500
8/31/90	Payroll Journal	120,200
9/30/90	Payroll Journal	170,500
10/31/90	Payroll Journal	100,170
11/30/90	Payroll Journal	170,500
12/31/90	Payroll Journal	105,260
1/31/91	Payroll Journal	170,500
2/28/91	Payroll Journal	120,200
3/31/91	Payroll Journal	170,500
4/30/91	Payroll Journal	110,000
5/31/91	Payroll Journal	170,500
6/30/91	Payroll Journal	110,000
6/30/91	C/D Journal	<u>75,000</u>
	Ending Balance	\$1,763,830
		=====

**Exhibit 3-1 (5 of 5)**

2. Per the general ledger, the cost of sales wages is a total of the following accounts:

A/C #5010 Wages - Cutting & Sewing	\$294,720
#5020 Wages - Factory Wood	255,830
#5030 Wages - Finishing	358,630
#5040 Wages - Temporary Help	50,000
	-----
Total	\$959,180
	=====

3. The examiner questioned the taxpayer's CFO and discovered the following:

- a. The \$75,000 debited to Officers' Compensation represented a bonus paid to the corporate president, Mr. Able. The bonus was not included in the reports submitted to the payroll service, thus this amount was not included in Mr. Able's 1991 Form W-2. Inspection of the Form W-2 revealed his wages exceeded the withholding limitations for all payroll taxes. Review of Mr. Able's Form 1040 for 1991 revealed that he reported only those wages shown on his Form W-2.
- b. During periods of peak production, the taxpayer hires additional workers for the various departments. The taxpayer mistakenly failed to treat these workers as employees, their wages were paid directly from the C/D Journal and not included in the payroll reports submitted to the payroll service, and the taxpayer did not withhold payroll taxes from these wages.

Based on the information gathered by the examiner, the following adjustments were proposed and agreed to by both the corporation and Mr. Able:

- 1) Oak Corporation's employment tax returns were opened for examination and adjusted for additional taxes associated with the \$50,000 in wages paid to the temporary workers.
- 2) Mr. Able had additional income of \$75,000 on his Form 1040.

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INTERNAL REVENUE SERVICE

Department of the Treasury

District  
Director

Date:

>

Dear Taxpayer,

Internal Revenue Code section 6050I provides in part, that any person who in the course of carrying on a trade or business receives more than \$10,000 in cash as defined by Treasury Regulations section 1.6050I-1(c) in one transaction, or two or more related transactions, must file Form 8300. Any transactions conducted between a payer (or its agent) and the recipient in a 24-hour period are considered related transactions and must be aggregated and reported as a single transaction if the total amount exceeds \$10,000. Also, a transaction is related even though it occurs during a period of more than 24-hours if the recipient knows, or has reason to know, that each transaction is a series of connected transactions. For amounts received on or after February 3, 1992, the term "cash" includes cashier's checks, bank drafts, traveler's checks, and money orders with a face amount of \$10,000 or less received in certain types of transaction.

The Form 8300 must be filed with the Internal Revenue Service by the 15th day after the date of the transaction.

An annual written statement must be provided to each payer on or before January 31 of the following year following the calendar year in which a Form 8300 is filed. The statement must show the name and address of the business receiving the cash and the total amount of reportable cash received during the year from the payer and that the information is being furnished to the Internal Revenue Service.

For additional information on the Form 8300 filing requirements, please refer to Internal Revenue Code section 6050I, and the Form 8300 and instructions.

Sincerely,

Revenue Agent

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**Exhibit 3-3 (1 of 2)**

**Currency & Banking Compliance Program  
Package Audit Checksheet**

Entity Name:	Taxpayer ID Number:
Address:	Is this a Primary Business? (see reverse)
City            State            ZIP	If yes, specify type of business (CBRS queried?)
Person Interviewed/Title	Date of Examination
Year(s) of Examination	Form Filed (circle one) 1040    1065    1120    Other

			Not
	Yes	No	Applicable
1. Was the letter provided to the appropriate official?			
2. Was the official aware of 6050I requirements?			
3. Were the retained copies of Form 8300 inspected? If so, how many?			
4. If the TP is the "identified person," i.e. spending the cash, were IRP transcripts matched to the return?			
5. Did the TP have any foreign bank accounts?			
6. If so, were Forms 90-22.1 filed?			
7. If required, did the TP file Form 3520, Creation of Transfers to a Foreign Trust?			
8. If required, did the TP file Form 3520A Annual Return of Foreign Trust with U.S. Beneficiaries?			
9. If required, did the TP file Form 926, Return by a Transferor of Property to a Foreign Corp., Foreign Trust or Estate or Foreign Partnership?			
10. If entity is a financial institution subject to Title 31, are the reporting requirements (re: filing of Forms 4789, Currency Transaction Reports), met?			
11. If required, did the TP file Form 4790, Report of International Transportation of Currency of Monetary Instruments?			

Other Information:

Examiner's Name:	<b>Prepare in duplicate.</b> AS SOON AS THE PACKAGE AUDIT IS COMPLETED, SUBMIT: 1 copy to case file 2 copies to group secretary
Group #:	
Phone:	

**Primary Businesses**

**NOTE:** Examiners must query the Currency & Banking Retrieval System (CBRS) when examining these types of businesses.

Listing of businesses/industries with a high potential for cash transactions.

**Category I--Dealers**

Auto dealers  
Airplane dealers  
Boat dealers  
Coin/stamp dealers  
Gem dealers  
Jewelry dealers  
Precious metal dealers  
Recreational vehicle dealers  
Trailer dealers

**Category II--Clubs**

Country clubs  
Exclusive clubs  
Yacht clubs

**Category III--Financial Services**

Title companies  
Escrow companies  
Insurance companies  
Loan/financial transactions

**Category IV--Professional Services**

Attorneys  
Auction houses  
Bail bondsmen  
Construction companies  
Interior decorators  
Pawn brokers  
Real Estate brokers  
Ticket brokers  
Warehouse lumber yards

**Category V--Retail**

Antique shops  
Exclusive furniture stores  
Exclusive men's/women's shops  
Furriers  
Rug & Carpet Sales  
Travel Agencies

**Category VI--Other**

Production Credit Associations

**Exhibit 3-4**

**Currency and Banking Retrieval System (CBRS) Request**

1. Subject Identification Data	3. Requester Information
<p>A. Name (last, first, middle) _____</p> <p>Alias _____</p> <p>Alias _____</p> <p>B. Last Known Address Number and Street _____</p> <p>City _____</p> <p>State _____ ZIP _____</p> <p>C. SSN/EIN _____</p> <p>D. Date of Birth _____</p> <p>E. Other:</p>	<p>Name _____</p> <p>Office Location _____</p> <p>Mailing Address _____</p> <p>_____</p> <p>Phone _____</p> <p>Date of Request _____</p> <p>Approved: _____ Group Manager</p> <p>Send request to:</p> <p>_____</p> <p>Attn: CBRS Operator</p>
2. Type of Information Requested	4. Summary of Results
<p>_____ CTR (Currency Transaction Report)</p> <p>_____ CTRC (Currency Transaction Report by Casinos)</p> <p>_____ Form 8300 (Report of Cash Payments Over \$10,000 Received in a Trade or Business)</p>	<p>_____ No Record</p> <p>_____ See Attached</p> <p>_____</p> <p>_____ CBRS Operator _____ Date</p>
<p>Remarks</p>	

**SUBMIT IN DUPLICATE**

ROWR FORM 3339-1 (5-87) Department of the Treasury-Internal Revenue Service

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## Chapter 4

### BALANCE SHEET

#### INTRODUCTION

The balance sheet is a very important component of the tax return for any Forms 1120, 1120S, or 1065. Since the focus of the study was mainly on corporations, an audit of a sole proprietor may need to be handled differently since no balance sheet is presented on an individual tax return and financial statements may not have been prepared.

A balance sheet audit provides a good supplement to an income statement audit. By auditing the balance sheet, you may find accounts which the taxpayer has handled incorrectly for tax purposes (that is, allowance for doubtful accounts, cash discounts reserves). This is not to say these accounts could not have been found through an income statement audit. A journal entry in the income statement account could be traced back to these balance sheet accounts. On the other hand, if you focused strictly on the income statement, you could miss these accounts entirely if there was no activity (no income statement write-off) for the year of audit.

Since balance sheet accounts are real accounts (year end balances are carried forward), proposed adjustments can carry many years worth of accumulations. Determine whether the questioned account provided the taxpayer any tax benefit. You also must determine whether the questioned account constituted a method of accounting. Thus, you must determine that the questioned account involved the erroneous treatment of a material item. A material item is any item which involves the proper time for inclusion of the item in income or the taking of a deduction. See Treas. Reg. section 1.446-1(e). If the questioned account involves the erroneous treatment of a material item in prior and current years, an adjustment may be warranted.

### **Example 1**

To illustrate, the following example uses both scenarios discussed above:

A tax return balance sheet contains an account called Reserve for Sales Discounts. The balance at the beginning of the audit year was \$50,000 and \$75,000 at the end of the year. The current year increase to the account was \$25,000. Presently, the examiner does not know whether there will be an immediate tax effect.

Scenario one: Upon further investigation, the following is determined:

1. No Schedule M-1 adjustment for the \$25,000 increase in the account was made.
2. Sales were reduced by the \$25,000 increase in the reserve for sales discounts.
3. Taxpayer cannot explain why adjustment was made.
4. Similar adjustments were made each year either increasing or decreasing the account with no corresponding Schedule M-1 adjustments.

Based on these facts, the examiner would propose the following adjustments:

1. A \$25,000 current year adjustment for the increase in the reserve account under Treas. Reg. section 1.461-4(g)(3) because the reserve method is not allowed, in most cases, for tax purposes; and
2. A \$50,000 adjustment for the accumulation under IRC section 481 because of the incorrect accounting method used in the prior years.

Scenario two: Upon further investigation, the following is determined:

1. A Schedule M-1 adjustment was made for the \$25,000 increase in the account during the year.
2. Examiner reviews the adjusting journal entry to convert book accounts to tax accounts and notices this entry reverses the original entry which had previously reduced sales for the year.
3. Taxpayer has handled this account the same way each year.

Based on these facts, the examiner does not have an issue with the current increase in the account of \$25,000 or the accumulation of \$50,000 because the taxpayer has not received any tax benefit from these reserves in either the current or prior years.

## **INTERRELATIONSHIP BETWEEN BALANCE SHEET AND INCOME STATEMENT**

As illustrated in scenario one above, when adjustments are proposed to a balance sheet account, the effect will usually be to taxable income unless proven otherwise. One exception to this rule would be a conversion of current year borrowings by the shareholder into a constructive dividend. (This is assuming the taxpayer has earnings and profits as defined in IRC section 312. See IRC section 301(c) to determine how to handle a distribution if taxpayer has no earnings and profits.) The reason adjustments to a balance sheet account usually have an effect on the income statement is because both are interrelated. All income statement accounts will run through the balance sheet. For example, a sale of merchandise would be booked as follows:

DR Accounts Receivable  
CR Sales

When the accounts receivable is collected, the entry would be:

DR Cash  
CR Accounts Receivable

However, not all balance sheet accounts will run through the income statement. In the previous example, the conversion of loans to shareholder into a constructive dividend, in all likelihood, was not expensed by the corporation thereby having no effect on the income statement. The entry to adjust these accounts and which should be proposed by the examiner would be:

DR Retained Earnings  
CR Loans to Shareholder

## **EFFECT OF BALANCE SHEET ADJUSTMENTS ON TAXABLE INCOME**

At the end of the year, the income (sales) and expense accounts are closed out into retained earnings. The net result is either net income or net loss. If you find an unexplained increase in the cash account, it may be an indication of an income understatement. Based on this principle, an adjustment to a balance sheet account will usually have the following effect on taxable income ("T.I."), unless proven otherwise.

## Adjustments to Balance Sheet Accounts

	Increase	Decrease	
Assets	+	-	+ = Increase T.I.
Liabilities	-	+	- = Decrease T.I.

Remember, not every adjustment to the balance sheet has an effect on taxable income. This was illustrated previously in the conversion of loans to shareholders into a constructive dividend.

### **PRELIMINARY AUDIT STEPS**

To gain an understanding of how the balance sheet is comprised, there are two steps which should be performed in all cases and with every account on the balance sheet.

#### **Reconcile the Book Accounts to the Return**

This is a very important step. By reconciling the books, a better understanding of how the accounts are classified is gained and it also requires you to contemplate every account title which could create many questions (that is, accounts receivable reserve). The taxpayer may have one or several general ledger accounts per line item on the balance sheet. Either way, you should have a better understanding of the general ledger accounts and a feel for how the books work after the reconciliation.

One of the primary reasons for this reconciliation is to uncover potential problems thereby preventing future confusion. To illustrate:

##### Example 2

Examiner Adams discovers the receivables per the tax return is less than the receivables per the books. He decides to propose an increase in the accounts receivable and, therefore, an increase in sales. He informs Accountant Bates about this adjustment and its effect on taxable income. At this point, Bates says, "I knew about this adjustment before you started the audit, it was a classification error." Bates pulls out his trial balance which shows the difference was in the Other Assets account. An accounts receivable account was accidentally combined with the Other Assets account on the return, causing an overstatement in the Other Assets and an understatement in the Accounts Receivable. The difference between the Other Assets account on the return and the general ledger accounts for Other Assets is the difference he was ready to propose an adjustment for. This could have been avoided if a line-by-line reconciliation had been performed since this would have highlighted the error in the Other Assets account beforehand. Once the book accounts have been reconciled to the return, Examiner Adams will be auditing the books and not the return.

## Comparative Analysis

The next step is to perform a comparison of the balance sheets of the prior year, audit year, and the subsequent years. If there are schedules attached, these should also be included in the comparison. From this comparison, you may notice large fluctuations or no fluctuations at all between the years. Either of these situations could warrant further questioning or audit work to be performed.

## AUDITING A BALANCE SHEET ACCOUNT AND SCHEDULES M)1 AND M)2

The steps involved in a balance sheet audit are different than those for the income statement. In a balance sheet audit, you are concerned with analyzing the year end components of an account and the related tax effect on the income statement. This differs from an income statement approach which emphasizes entry selection throughout the whole year.

Taxpayers may take the position an income item is not required to be recognized for tax purposes in the year of audit, but will recognize it for financial purposes. The same holds true for expenses, but emphasis may be on acceleration for tax purposes. In both scenarios listed, a Schedule M-1 adjustment will have been made to account for the differences.

### Example 3

Taxpayer ABC is on the cash method of accounting for tax purposes under IRC section 448, but on the accrual method for book. The accounts receivables account had the following balances: \$48,000 at the beginning of the year and \$65,500 at the end of the year. The following balance sheet and Schedule M-1 shows how this would appear:

Schedule L:

	Beg of tax year	End of tax year
	-----	-----
Accounts Receivable	48,000	\$65,500

Schedule M-1:

1. Net Income (Loss) per books	89,714
2. Federal Income Tax	30,286
	-----
6. Add lines 1 through 5	120,000
7. Income Recorded on books this year not included on this return: Accts Receivable (65,500-48,000)	17,500
	-----
9. Add lines 7 and 8	17,500
	-----
10. Income (line 28, page 1) line 6 less line 9	102,500
	=====

When the Schedule M-1 shows income or expenses handled differently between book

and tax, questions should be raised as to the reasons why. Some reasons may have merit, while others will not. In either case, taxpayers should be questioned regarding their authority for handling the issue in a particular fashion. In addition, you should research the issue yourself and draw your own conclusion as to the proper handling of the issue.

In regards to furniture manufacturing cases audited, different balance sheet accounts were examined in each audit and only those found to be of significance will be discussed. If a balance sheet account is not discussed, no inference should be drawn that an audit issue may not exist. Accountants can classify accounts altogether differently than the next, therefore, you will never know what to expect. In addition to discussing the Schedule M-1 & M-2, the following balance sheet accounts will be discussed:

- |                               |                                    |
|-------------------------------|------------------------------------|
| 1. Cash                       | 6. Accounts Payable, Other Current |
| 2. Account Receivable         | Liabilities & Other Liabilities    |
| 3. Inventory                  | 7. Capital Stock/Capital Account   |
| 4. Loans to/from Shareholders | 8. Retained Earnings               |
| 5. Building and Equipment     |                                    |

## Cash

The cash account is very important because it provides an indication of what to expect during the audit (that is, poor bookkeeping versus good bookkeeping, weak internal controls versus strong internal controls, missing records versus very organized, detailed records). In the cases which had poor bookkeeping, missing records, and lack of proper internal controls, more difficulties were encountered by examiners. However, in the majority of these cases, significant adjustments were made as a result of the poor bookkeeping.

The audit techniques performed on the cash account included:

1. Reconciliation of the book balance to the return. If cash does not reconcile, inquire into the reasons why. There should be no adjustments to get from the book to the return since no timing or permanent adjustments are required.
2. Reviewing the year end bank reconciliations. Secure all the bank statements for the entire year and all year end reconciliations. The year end bank reconciliations should be reviewed for accuracy and for any old outstanding checks beyond the time period they may be honored by the bank (each bank may be different, but the industry standard is 6 months). To review the bank reconciliation for accuracy, perform the following:
  - a. Compare the bank statement balance with the per bank balance in the

reconciliation.

- b. Trace any deposits in transit from the reconciliation to the book to determine whether they have been included in the book balance.
- c. Trace any bank credits to the book for proper inclusion (that is, interest income).
- d. Inspect the list of outstanding checks and question any old outstanding checks. In addition, any large dollar checks still outstanding at year end, may want to be questioned. A reason to question a check of this nature is because the taxpayer may not have booked an expense through accounts payable but instead went directly against the cash account. The following is a typical entry which bypasses the accounts payable account:

DR Expense  
CR Cash

In the entry above, the taxpayer may void this check in the subsequent tax year because it was not a valid expense. What they have done in effect is lower their taxable income for the audit year by writing a check and voiding it the next year. When they void it the next year, this will increase their taxable income in the subsequent year because they will reverse the entry above. This adjustment becomes a timing issue, however, it could have a dramatic tax effect if the expense lowers the taxpayers taxable income enough whereby the tax rate for the year is changed from a higher to a lower bracket. In addition, there may be a tax bracket change between the 2 years either as a result of a law change or the taxpayer anticipating the subsequent year will not be as profitable.

- e. Question any material bank debits to determine the reason for them (that is, service charges, purchasing checks, customer checks having NSF).
- f. Foot the reconciliation and trace to the general ledger. Any differences should be questioned and if necessary, adjustments proposed. Sometimes, the taxpayer may not know where the difference is from and it may take you a long time to find the difference if it can be found at all. Therefore, propose an adjustment to the cash account on the Form 4549. By adjusting the cash account to the correct amount, the offsetting entry will be to the retained earnings account which is in effect taxable income. If the taxpayer does not agree with the adjustment, the burden is now on the taxpayer to prove this was not income. Therefore, try to rule out any loans or capital contribution which may not have been recorded. Remember, you are not the taxpayer's

bookkeeper. Therefore, the burden is on the taxpayer to prove otherwise.

- g. Inspect subsequent months bank statements in the next tax year for any unusual items.
- h. Inspect the subsequent month bank statement and reconciliation to determine whether any deposits were not included in the year end bank reconciliation (deposits posted 1 to 3 days after the close of the year). It may have been necessary for these deposits to have been included in the year end bank reconciliation. Again, this would be a timing adjustment only and it may or may not have an effect on the balance sheet. For example, if there was a collection of an accounts receivable, an adjustment to taxable income may be necessary if the taxpayer has credited the accounts receivable account in the audit year for the in transit deposit not included in the year end reconciliation. By failing to debit the cash account, the balance sheet is now out of balance. Therefore, to correct this problem, the taxpayer may force the balance sheet accounts to balance or they may have a balance sheet which is out of balance.

If, on the other hand, the taxpayers' bank statements do not fall on the same date as the year end, other work will be necessary to reconcile the account. Sometimes, the taxpayer will request a cut-off statement from the bank which ends on their year end, this will be very helpful if available. However, if the taxpayer did not request one, the same steps above should be used, however, the subsequent months bank statement will be necessary to perform some of these steps. You will need to review the subsequent months bank statement for any transactions up to the year end date.

- 3. Review bank statements for unusual items and electronic transfer. The bank statements should be reviewed for any unusual items which are outside the normal course of business operations (that is, large withdrawals, deposits in round numbers, electronic transfers in or out). These transactions should be traced to any other bank account utilized and questions should be raised regarding transactions the examiner is unable to trace.
- 4. Scan canceled checks and compare to the disbursements journal. Scan a few months worth of canceled checks (if a small company, maybe the whole year, time permitting). The cash disbursements journal should be compared with the canceled checks selected. When scanning checks, be aware of:
  - a. Any differences between the payee on the canceled check and the disbursements journal;
  - b. Any unusual payees which do not correlate with the taxpayer's business;

- c. Endorsements which are different than the payees name on the face of the check;
- d. Checks cashed at grocery stores or check cashing places; or
- e. Hand written endorsements or non-corporate entities.

If checks are found with these conditions, write down as much information as possible such as check number, date, payees name, vendor number if present, dollar amount, and perhaps the bank account number used with the endorsement. These questionable checks should then be traced back to the general ledger account and the taxpayers' retained copies of Forms W-2 and 1099. By performing these steps, you may find adjustments for personal expenses, possible employment tax issues, or even a nonfiler. The employment tax issue may either be possible payments made to employees which did not get reported on a Forms W-2, 940, or 941 or for payments made to independent contractors not reported on a Form 1099. In addition, there may be a problem with the amounts reported on Forms 1099 filed. For additional information on how to handle additional payments paid which were not reported on the information return or for payments not reported on any information return, see Chapter 3, the sections on employment taxes, information returns, and backup withholding.

If vendor reports are available, request them for the individuals in question. This may save time by listing all pertinent checks. If unable to obtain a vendor report, you must decide whether to expand the scope to include additional months or accept the months scanned. Sometimes, you may be able to pinpoint the general ledger account the questionable payments are being booked to. However, many times the payments may be spread among many different accounts.

- 5. Review bank statements for any income earned on bank accounts. The accounts should be reviewed to determine whether the account has earned any interest. Any interest should be traceable to an income account. In addition, if the taxpayer has reported interest income on the return this should be traced back to the bank statement. One team member found an additional bank account the taxpayer had not included on the balance sheet by following this step.

### **Accounts Receivable**

One of the larger accounts on the balance sheet will be accounts receivable. IRC section 448 gives a brief definition of who is not allowed to be on the cash method of accounting. Treas. Reg. section 1.446-1(c)(2) requires taxpayers to be on the accrual method of accounting if inventories are necessary and Treas. Reg. section

1.471-1 provides the criteria for when inventories are necessary. Therefore, most furniture manufacturers will be prohibited from using the cash method of accounting for tax purposes. Thus, there should be some accounts receivables listed on the balance sheet. If none are shown, question the accountant in charge for the reasons why. This should then be verified. A valid reason encountered was, all jobs required payment up front. Therefore, customer deposits were listed instead, which are liabilities and not assets.

Because the taxpayer will, for tax purposes, try to defer income as long as possible, you will not be able to use the same audit approach as if a financial audit was being performed. For financial accounting, recognizing income at an early stage makes the company appear stronger than they may actually be. Thus, different audit steps are used for a tax audit than would be used for a financial audit.

Audit techniques used for accounts receivable are listed and will provide you with some guidance. The following steps do not have to be worked in the order listed, but it is recommended since this sequence starts with the easier steps and progresses to the more complex and time consuming ones.

1. Reconciliation of the book balance to the return. The accounts should be reconciled and any difference between book and return questioned first by reviewing the adjusting journal entries at year end or the Schedule M-1. If still unable to reconcile, question the accountant. You should be concerned with the possible write-off of a bad debt reserve. The Tax Reform Act of 1986 limited the use of the reserve method for bad debts under IRC section 166. However, in a few cases, taxpayer's tried to use the reserve method either by setting up the reserve directly on the books and not making any adjustments through the Schedule M-1 or by netting their accounts receivable with the reserve, with again, no Schedule M-1 adjustment. Therefore, if the balance sheet lists an Allowance for Doubtful Accounts, close scrutiny should be placed on it to determine if any increase in the reserve was written-off.

You are reminded that the taxpayer can increase the reserve for financial purposes all they want, but there should be a corresponding M-1 adjustment reflecting this increase. If no M-1 adjustment is made, a possible issue exists. As for the direct write-off against the accounts receivable, this will usually only be found if a direct line-by-line reconciliation is performed. The taxpayer will have their reserve account on the books but when it is recorded on the return, the reserve amount is not recorded as a separate line item. Again, if this is found and no M-1 adjustment was made, a possible issue exists.

2. Review year end adjusting entries. The year end adjusting entries to go from book to return should be reviewed for any unusual entries or entries not made. As mentioned above, the taxpayer will try many creative ways to disguise reserves. During an audit by one of the team members, a reserve for defective products was found during the review of the year end adjusting entries.
3. Reviewing the accounting records. Review the accounting records to determine exactly what type of parties or customers make up accounts receivables. If a computer is used for bookkeeping, you will probably be reviewing an accounts receivable aging schedule. However, if the system is based on manual entries, either partially or fully, you will probably be reviewing a summary of all the accounts receivable ledger cards. Ask questions at this stage to gain an understanding of how the taxpayer prepared their schedules and their policy regarding write-offs.
4. Run 10-key check. Never be under the impression the schedules provided will foot or cross foot, even if they are computer generated. Easy and sometimes large adjustments are found when math errors have been made. A few cases worked by the team members resulted in large adjustments to the accounts receivables because they were understated.
5. Tie ledger cards to the reports. If there are numerous ledger cards, you may want to review a sample. However, if there are only a few, tie these ledger cards back into the schedules provided. In addition, you may want to foot some of the ledger cards on a sample basis to make sure their controls are in place.
6. Scan ledger cards. Scan the ledger cards looking for anything unusual about the clients name, address, balances outstanding, and if listed, their credit limit. Sometimes, the taxpayer will indicate on the ledger card, the credit limit allowed the client. By doing this, they have a built-in control whereby the credit manager can stop any order which may exceed the credit balance allowed.

One adjustment proposed resulted from this check. When scanning the ledger cards the agent noticed the shareholder's son-in-law's ledger card had an open balance (no credit limit). The balance in the account kept increasing with very few payments being made. Finally, the son-in-law's retail store went out of business in the subsequent year and the balance of the account was written-off as uncollectible. No attempt was made to collect from the son-in-law or the daughter. The agent proposed an adjustment at the corporate level under IRC section 166 and an adjustment at the shareholder level under IRC section 301 for the amount written-off as uncollectible.

7. Review the accounts receivable reports. The accounts receivable report should be reviewed to determine if credit balances exist. If credit balances exist, questions should be raised as to the age of the balances and the reason for the balances. If the balances are old and no activity has occurred on the account in many months or years, an income adjustment should be considered. If the balances are old, there is a good possibility the taxpayer is not going to refund the money or their client, for one reason or another, failed to use credit memos issued on past returns or allowances. Therefore, what they have in effect is income. To illustrate this, the following is the entry the taxpayer would most likely make when their client made payment even though it was more than the original sale amount:

DR Cash  
CR Accounts Receivable

To clear the Accounts Receivable credit off the books, the taxpayer should make the following entry, however, this is not to say this is what you may see because the taxpayers can become very creative:

DR Accounts Receivable  
CR Income

Along with this audit step, bad debts written-off during the year should be compared with this report. The taxpayer may be premature in their write-off policy. Some indications may be:

- a. Sales still being made to their client after the write-off
  - b. Many accounts written-off in prior year being brought back into income in the subsequent year
  - c. Sales made to their client up to the end of the tax year.
8. Compare the recorded amount with the invoice. This step was not performed often because the taxpayers examined dealt strictly with checks and seldom received cash. In addition, if internal controls are adequate this step can be by-passed in most cases.
  9. Inspect subsequent year billings. This step involves inspecting subsequent year sales invoices and comparing with year end inventory records. Many taxpayers will avoid billing their clients until the following day(s) after the end of the tax year, but will not include the goods in finished goods inventory for one reason or another. This audit technique is easier with smaller companies than on a larger shop which has the capacity to produce in large volumes at a very fast rate.

However, this does not preclude this technique from being applied to larger manufacturers.

When inspecting the subsequent year billings, if you finds many customers being billed a few days after the close of the tax year, the year end inventory records should be inspected to determine if the taxpayer had inventory on hand at year end to fill these orders. If the taxpayer did not have the inventory to support these invoices, they should be asked why and how they were able to invoice a few days after the beginning of the new tax year. If it is found these invoices are for finished products which were not included in the year end count, secure production schedules from the beginning of the new year up to the date of the invoice. From these, you should be able to determine if the taxpayer had manufactured the product after the year end inventory count. If it is found, the product was not manufactured in the new year, an ending inventory adjustment will be necessary.

If the taxpayer does not use production schedules, you will have a problem trying to determine if the product was manufactured in the new year. Therefore, scan the billing invoices and the shipping documentation for these invoices and then ascertain from the taxpayer the production times required to complete a product. From this information, you should be able to estimate a date you believe is acceptable as a cut-off date for the matching of the invoices with the year end inventory count.

To illustrate, the facts from a furniture case will be used to explain the application of this technique. The taxpayer's subsequent year billings were inspected. The agent noticed about 23 invoices billed the day after the year end. This taxpayer did not bill on a daily basis but instead would wait until they accumulated a few billings before the invoices were prepared. Three other groups of invoices were billed only a few days apart, then another group was billed on the 10th of the month with the next group billed 7 days later. Based on this, the agent noticed there was a natural break between the 10th and the 17th, therefore, the agent decided to cut-off this check at the invoices issued after the 10th. The invoices included in this check were issued on the 1st, 2nd, 4th, 9th, and 10th. The agent scheduled out these invoices and then traced back to the ending inventory. A few items were traced to the ending inventory count, but the rest were not. At this point, a 10-key tape was run on the invoices not traced to ending inventory. The total for these 10 days represented almost 10 percent of the total sales for the subsequent year.

The adjustment is computed using either one of two different methods. If the company keeps production schedules, these can be used to determine how far along in the production process the product was. From these, determine the costs incurred as of the end of the year. However, it is unlikely the you will find a taxpayer who uses production schedules having the problems stated above.

Another way of computing the adjustment will be discussed in Chapter 6, Cost of Sales, utilizing subsequent years sales with gross profit ratios.

Two side notes about this technique. First, the time frame for production from start to finish will be longer for a custom shop than it would for a production shop. The reason for this is the custom shops are slower in their production because of the detail involved. Therefore, when using this technique, take this into consideration when trying to determine a cut-off date. In the previous example, this was a custom shop and as can be seen the cut-off date was determined to be the 10th. Second, you may be able to take the position the invoices in question should have been in income in the audit year instead of inventory. This will require more work such as reviewing shipping invoices or contacting the taxpayer's customers.

### **Inventory**

Refer to Chapter 6, Cost of Goods Sold for audit techniques.

### **Loans to/from Shareholders**

The corporate balance sheet should be reviewed for the existence of loan accounts either to or from the shareholder. However, no entry on the balance sheet for shareholder loan accounts does not mean there are no outstanding loan balances. In several cases, it was noted the shareholder loans were included in asset and liability accounts other than the normal loans to or from shareholder account. Thus, during the initial interview, inquire as to the existence of loans and the taxpayer's policies with respect to the loan, repayments, interest rates, and collateral.

Once the existence of a shareholder loan is established, the concern is whether the loans are arms length transactions (that is, length of loan, interest rate, etc.). The shareholder could be receiving an interest free loan or they may be taking money out of the company tax free, through forgiveness of the loans by the corporation at a later date. Therefore, request copies of the loan documents. If loan documents exist, they will show the terms which you can then validate. If loan documents are not available, review the corporate minutes for a possible mention of and the details of the loans.

In regards to interest generated by a loan from shareholder, you must inspect the payables accounts for a possible write-off of the interest owed the shareholder which has not been paid. IRC section 267(a)(2) states the corporation and the shareholder (who must hold a greater than 50 percent interest in the company either directly or by attribution) will be put on the same basis of accounting, usually cash basis, to determine when a write-off is allowed, even though one is an accrual basis and the other is cash basis. In simpler terms, the corporation will be allowed a deduction when the interest is paid, not when it is accrued. However, if the corporation has

accrued the expense, inspect the Schedule M-1 to determine whether the amount has been backed out for tax purposes. To illustrate this point, the following example is from an actual case worked by one of the team members.

**Example 4**

During the audit of a corporate taxpayer with a tax year 9206, the agent noticed the corporation had deducted \$125,000 as interest expense which was related to a shareholder loan. Upon further review, it was found the corporation had only paid \$75,000 with the other \$50,000 being an accrual. This accrual of \$50,000 was finally paid prior to the end of the 1992 year. Even though the shareholder was required to include the full \$125,000 in his 9212 year, the corporation was not allowed a deduction for the accrual of \$50,000 in the 9206 year, but instead was allowed it in their 9306 year.

1. Demand Loans

Often, the loans between the taxpayer and its shareholder will be demand loans in lieu of formal loans with a stated rate of interest and repayment period. In the case of demand loans, special rules apply. Under IRC section 7872, the foregone interest on such below market interest rate loans is treated as transferred from the lender to the borrower as of the last day of the calendar year and retransferred immediately from the borrower to the lender as interest. There is a \$10,000 de minimis exception for compensation-related and corporate-shareholder loans that do not have tax avoidance as one of the principal purposes (IRC section 7872(c)(3)).

When a corporation makes interest free (or low interest) loans to its shareholders, the shareholders' family members, or other related parties as discussed in IRC section 318(a), the following actions are deemed to have occurred:

- a. The shareholder has received a constructive dividend in the amount of the foregone interest to the extent of earnings and profits.
- b. The corporation receives a like amount of interest income.
- c. After the 1990 year, the shareholder will only be allowed a deduction for the interest deemed paid to the corporation if they can demonstrate the expense is investment related.

If the corporate loan is made to an employee, who is unrelated to the shareholder as discussed in IRC section 318(a), the scenario is similar except:

- a. The foregone interest is characterized as additional compensation to the

employee.

- b. The corporation receives deemed interest income in a like amount.
- c. The corporation can deduct the amount as compensation expense but may be liable for employment taxes on the additional wages.
- d. After the 1990 year, the employee will only be allowed a deduction for the interest deemed paid to the corporation if they can demonstrate the expense is investment related.

When a below market interest rate loan is made between otherwise related entities, or a shareholder makes a loan to his or her corporation, the adjustments resulting after imputing the interest are:

- a. The shareholder receives interest income in the amount of the foregone interest.
- b. The corporation has deemed interest expense in a like amount.
- c. The foregone interest will be treated as a capital contribution by the shareholder (Treas. Reg. section 1.7872-4(d)).

Although the transfer of taxable income between entities may appear to be offsetting, there can be significant tax impact in the reallocation, depending on the relative tax brackets of the borrower and lender and the deductibility of the interest deemed paid.

The regulations contain detailed instructions for computing the interest imputed on interest free and below market rate loans using published federal rates and should be consulted for guidance. A simplified method is available for use in imputing interest on loans of \$250,000 or less. If loans exceed this amount, a business or financial calculator capable of raising "x" to the "y" power, will be required.

Despite the fact the computation may seem somewhat tedious at first, adjustments can be substantial and are easily sustained.

## 2. Thin Capitalization

Upon reviewing the loans from shareholder and the common stock accounts, a thin capitalization issue may exist if there is little or no common stock and there is a large loan from the shareholder. IRC section 385 was enacted for the purpose of determining whether an interest in a corporation is to be treated as stock or

indebtedness. Under this section, there are five factors which need to be considered in pursuing this issue, therefore, if you encounter this issue, this section of the Code should be reviewed along with any court cases related to this issue. In the narrative below, a few court cases are discussed which should be researched further.

The objective, in a thin capitalization issue case, is to convert a portion, if not all, of the loans from the shareholder to common stock. By performing this conversion, an adjustment to the interest expense will be necessary because the loans at this point will be considered non-existent. The interest paid by the corporation, which has been disallowed by an examiner, will now be classified as a dividend at the shareholder level to the extent of earnings and profits.

The courts have not been favorable in the Government's pursuit of this issue. (**Fin Hay Realty v. United States**, 22 A.F.T.R. 5004, 398 F.2d 694). In the courts opinion, equity is considered a higher risk, whereas to loan money is considered a lower risk. Thus, to loan money to one's corporation is in effect limiting their risk because equity is only allowed a capital loss, but loans can be afforded the benefit of being classified as ordinary losses under IRC section 166. In addition, the courts have stated a shareholder would not loan their corporation money at extraordinary rates because this would be self-defeating as it would damage their own corporation. In the **Fin Hay** case, the presiding judge quoted the **J.S. Birtz Construction Co. v. C.I.R.** case at which time the court made a strong point about loans and equity.

"Financing embraces both equity and debt transactions and we do not think the courts should enunciate a rule of law that a sole stockholder may not loan money or transfer assets to a corporation in a loan transaction. If this is to be the law, Congress should so declare it. We feel the controlling principle should be that any transaction which is intrinsically clear upon its face should be accorded its legal due unless the transaction is a mere sham or subterfuge set up solely or principally for tax-avoidance purposes."

Even though this is not a particularly easy issue to work, this should not deter you if the situation arises. In one case, a team member noted a corporation had no common stock outstanding. It was determined, from the corporate minutes, they had converted the common stock to loans from shareholder in a prior year and had paid interest on this amount every year since. Obviously, this issue was easily disposed. The agent proposed the following adjustments: 1) increase to the common stock account; 2) decrease to the loans from shareholder account; 3) disallowed a portion of the interest expense; and 4) reclassified interest income at the shareholder level to a constructive dividend.

## **Building and Equipment**

In this section, the term account(s) and depreciation schedule will be synonymous.

The building and equipment account will be one of the larger balance sheet accounts for a furniture manufacturer return. However, combined with the accumulated depreciation account, the net balance of the two will usually decrease every year. When reviewing this account, the notes made during the initial interview and the tour of the business should help determine what should or should not be in the account. For example, corporate officers may be driving expensive luxury vehicles which do not appear on the depreciation schedule. This could mean the vehicles are being leased by the corporation, therefore, you should be aware of potential adjustments under the luxury automobile limitations per IRC section 280F (A-550). In addition, during the tour of the business if you notice all the machinery looks old, questions should be asked about any equipment purchases made recently which appear on the depreciation schedule. The audit techniques used on the building and equipment account were:

1. Reconciliation of the book balance to the return. Again, this should be the first step performed before proceeding further. This reconciliation may be reconciling one account in the books to the building and equipment line on the return, different classifications of fixed assets (that is, machinery, furniture, and fixtures, etc.), or it could mean reconciling each piece of equipment which has their own account in the books to the building and equipment line on the return. In any case, you must reconcile and question any differences.
2. Review the depreciation schedule. If a depreciation schedule is not attached to the return, request one. This depreciation schedule should be reconciled to the book balance for the original cost of the equipment but it may not balance for the accumulated depreciation because of the different methods afforded the taxpayer both for financial and tax purposes. The depreciation schedule will usually be kept for tax purposes. If the taxpayer is using a different method for book than tax, a Schedule M-1 adjustment should appear for the current year differences.

The depreciation schedules for the prior year, audit year, and the subsequent year returns should be compared for any personal or nonbusiness related assets, changes in the depreciation method or the life of the assets, and any possible equipment dispositions not reported on the return. If these items are found, questions should be asked and, if necessary, adjustments proposed under IRC sections 162, 168, or 1231.

Scrutinize any IRC section 1031 like-kind exchanges to verify that the requirements for the exchange have been met. To find these transactions, inspect the invoices for any new equipment purchases made during the year. From this,

you should be able to determine if the basis of the new equipment was reduced by a trade-in.

In one case, the agent had reviewed the new equipment purchased during the year. One of the purchase invoices requested showed a larger dollar amount being paid for a vehicle than what was recorded on the depreciation schedule. Questions were asked and it was discovered a company vehicle was sold to a third party for cash and they had reduced the basis of the new vehicle by this amount, thus no gain was reported. Based on this, an adjustment was proposed for an ordinary gain on the cash received and the equipment basis was adjusted to the actual amount paid. The taxpayer would have been allowed an additional depreciation deduction, but since the equipment was listed property, the depreciation deduction was limited to the amount already claimed on the return.

3. Review the method of depreciation. Be aware of the specific methods allowable by the Code when reviewing the depreciation schedule. For instance, one should be aware of the various classifications (that is, 3, 5, 7 year etc.) as well as the methods available (200 percent declining balance, straight line, etc.). Also be aware of the various conventions (half-year, mid-month, or mid-quarter) for new acquisitions or disposals of equipment. If an IRC section 179 deduction is being claimed, verify the original basis of the asset(s) has been adjusted to reflect the proper deduction in subsequent years. Although the vast majority of the tax return depreciation schedules are now computerized, you needs to be aware if improper methods are input, then the resulting computation will be incorrect.

As a result of the Tax Reform Act of 1986, a majority of the furniture manufacturing equipment placed in service after this Act will be depreciated over a 7-year MACRS life (IRC section 168(e)(3)(C)). Under MACRS, any building acquired after 1986 is to be depreciated over a 31.5 year straight line method. In addition, any leasehold improvements made post-1986 are now required to be depreciated over the same 31.5 year life, not the life of the lease agreement as was the law pre-1987 (IRC sections 168(i)(6)(A) and 168(i)(8)). As a result of the Omnibus Budget Reconciliation Act of 1993, any real property placed in service, with exceptions, on or after May 13, 1993, is required to be depreciated over a 39-year straight-line method.

Since the allocation between building and land can make large differences in the amount of depreciation allowed, review the allocation and if necessary make an engineering referral for assistance in determining the correct allocation. In addition, inspect how the taxpayer is depreciating the building. In one case, the taxpayer had included the land in the calculation for depreciation which resulted in an accelerated write-off. The taxpayer knew they were not allowed to depreciate land because they had a separate line item for it. The bottom line was the building

should have been written-off over 30 years, but with the land being included in the basis for depreciation, the write-off period was effectively 22 years.

Per IRC section 168(g), equipment used predominantly outside the United States must use the alternative depreciation system ("ADS"). This method will extend the life of the asset. In the case of equipment, the usual life is 7 years but under ADS the life is now 10 years. Therefore, if the taxpayer owns a maquiladora and leases equipment to them, make sure the taxpayer is using the ADS method. See Chapter 8, Maquiladoras, for further discussion.

4. Scrutinize self-constructed assets. Some of the taxpayers audited had constructed their own assets (buildings or improvements). When this occurs, you should be concerned with direct write-off's of expenses associated with the construction of the asset. The larger dollar items will be capitalized but many of the smaller items will be expensed. Remember many small items can make a large adjustment.
5. Perform a sample of equipment and trace back to factory. You may want to sample some of the equipment listed on the depreciation schedules and trace them to the factory to verify their existence. The problem with this is the equipment selected may have a general name (that is, table saw) and the taxpayer may not have the receipt to verify the manufacturer and serial number. This usually occurs when the equipment is older. Once, the sample is pulled and traced to the factory, any difference, or missing equipment should be questioned. There may be a possible sale of equipment which was not reported or a IRC section 1031 exchange which would require verification.

### **Accounts Payable -- Other Current Liabilities and Other Liabilities**

Since each one of these accounts is similar in nature, the audit techniques to be listed can be applied for all accounts. As for the differences between these accounts they are as follows: An accounts payable account is used to record the daily expenses of the taxpayer, such as goods and services. Since these expenses are vital to the business, they will usually be paid in a timely fashion. Thus, finding old expenses is highly unlikely, unless the company is having financial problems. Because of the nature of the account, it is usually easier to audit because the amounts which comprise the account have already been expensed on the income statement. Therefore, the taxpayer has the burden of verifying these amounts. In reality, auditing this account becomes a substantiation audit.

Both the Other Current Liabilities and Other Liabilities are accounts which are not used on a daily basis but are instead used for accruals which do not ordinarily enter through the accounts payable system. For example, you will usually find the

current portion of a note payable listed in this section. Therefore, if an adjustment is made in this area, the effect will not always be to taxable income for the year. Other accounts you may find under these headings are: Accrued payroll taxes, sales commissions, workers compensation insurance, allowance for advertising, and reserves for estimated expenses or contingencies.

You can audit accounts payable for transactions occurring during the year, but due to the number of transactions, this method can be cumbersome. Also, this method is similar to an expense method of auditing and could simply be duplicated work. When auditing this account, you may want to concentrate on the year end balances. By auditing the year end balance, you will be able to verify whether the taxpayer has expensed items not meeting the conditions of IRC section 461(h) and Treas. Reg. section 1.461-1(a)(2) at year end or were not IRC section 162 expenditures. Treas. Reg. section 1.461-1(a)(2) has three conditions which are necessary for the amount to be deductible: 1) the liability must exist; 2) the liability can be reasonably determined; and 3) economic performance has occurred. If one of the three conditions is not met, an adjustment may be necessary.

Any adjustments necessary to the accounts payable account will most likely be adjustments to taxable income because the amount adjusted was written-off somewhere on the income statement. So, if you find a timing adjustment, you should attempt to find which income statement account was affected because it may lead to other audit areas or it may have an effect on the IRC section 263A adjustment. As with any adjustment, materiality will dictate how much time and effort will be necessary. If you are unable to locate the account for whatever reason (that is, time constraints), one could make an adjustment to the accounts payable account directly on Form 4549. However, if the adjustment found is of a personal nature, make every attempt to find the account affected, so concentration can be placed on this account for possible further personal adjustments.

Since this account is fairly easy to audit, the steps involved are fairly simple. The following are the steps you should take in auditing this account:

1. Reconciliation of the book balance to the return. Obtain the year end trial balance and reconcile the accounts to the tax return. By performing this step, you will be able to determine if the tax return balance is comprised of more than one general ledger account and possibly set the scope of accounts to be audited.
2. Secure and inspect the year end accounts payable schedule or breakdown of the ending balances. If possible, try to secure a copy of an accounts payable aging schedule or breakdown of the ending balances which lists all amounts which make up the year end balance. If the taxpayer does not have an aging schedule, a schedule of whom is owed money should be secured. If the taxpayer states they

do not have a list, consider a possible adjustment for the entire accounts payable balance because this account is used for the daily activity of the business. Therefore, under the accrual method of accounting if an entry is made to the accounts payable account, the offset would be to an expense account which in all likelihood has been written off by the taxpayer. So, if the taxpayer is unable to provide a list of their accounts payable, in effect they have told you they do not have any expenses, thus an adjustment is warranted.

As for Other Current Liabilities and Other Liabilities, if the taxpayer does not provide a breakdown, you will be unable to consider an adjustment for the entire balance because of the nature of these accounts. Further work will be necessary to establish whether these amounts have ever been expensed and if they have, whether they have been expensed in the previous years or the current year and whether the accrual meets the tests described in IRC section 461(h). This is necessary because if it is determined a change in accounting method is required, IRS procedures (Rev. Proc. 92-20) will dictate how the adjustment will be handled in the year of audit.

Once a schedule is secured, the following audit steps should be performed. These steps can be used for all liability accounts:

- a. Foot and reconcile. Foot and reconcile the balance to the general ledger amount. Any differences should be questioned and if necessary, adjustments proposed.
- b. Inspect for old payables. You will only be able to perform this step if an aging schedule is secured. However, if no aging schedule is provided the step listed in IRC section © below can be used.

Inspect for old payables which may require an adjustment. Since the Code does not specify a time period, use your judgment in determining what is considered old. A good starting point could be 6 months, but this could change depending on many factors. Some factors would be the financial condition of the taxpayer, industry standard, and whether the amount is being disputed. If an old payable is found and the taxpayer has indicated they are not going to pay, make an adjustment for this payable because of the explanation given in the introduction of this section.

- c. Sample payees/accounts. A sampling of the payees/accounts should be made and documentation requested to determine whether the deductions meet the three conditions listed in Treas. Reg. section 1.461-1(a)(2) which would allow the deduction.

In addition, you will want to inspect for payables which are old and still outstanding as of the audit date. If old payables are questioned, inspect the subsequent year payments to verify the amount was actually paid. If it is determined these payables have never been paid, an adjustment may be warranted.

3. Scrutinize any year end adjusting journal entries. Any adjusting entries at year end should be reviewed and questioned to determine if they meet the three conditions of Treas. Reg. section 1.461-1(a)(2) at year end. If the entries are questionable, documentation should be requested and the amount verified. If necessary, consider an adjustment to accounts payable if the amounts do not meet the conditions of Treas. Reg. section 1.461-1(a)(2).

### **Capital Stock/Capital Account**

Since many of the furniture companies audited have been around for a few generations, a reconciliation of the ownership account through the stock certificates/stock book was usually necessary. This reconciliation should be compared to the Schedule E or an ownership schedule attached to the return. Questions should be asked if the ownership does not reconcile to the return. The stock ownership should be reconciled early on during the audit so any adjustments for personal usage of corporate assets or distributions of corporate assets can be proposed to the correct individual.

The reconciliation of the ownership account is very important in a TEFRA and Non-TEFRA S-Corporation or partnership examination because of the nature of these entities. Any adjustments proposed at the entity level will in most cases have a direct tax effect at either the shareholder or partner level. To illustrate, in one of the cases an S-Corporation with three shareholders had allocated 100 percent of the losses to the 80 percent shareholder and none to the other two shareholders. The agent proposed adjustments at the shareholder level to correct this allocation. From the initial interview, the agent knew the two shareholders were passive investors, therefore, their losses were limited because of the passive activity rules under IRC section 469. A minor change in the K-1 reporting resulted in a substantial adjustment.

Because many of the companies are fairly old, the older shareholders will either gift their stock to the younger shareholders (usually family members) or sell the stock back to the company. Each transaction can have a tax consequence either through a gift tax or a capital gain under IRC section 1221. In addition, if a shareholder's stock is redeemed as treasury stock, IRC section 306 will govern the ex-shareholder's actions with the company for up to 10 years after the sale. If the ex-shareholder fails to comply with IRC section 306, the redemption could be classified as a dividend distribution. If any of these issues are found, further research will be necessary which

is outside the scope of this manual.

### **Retained Earnings**

As with any industry, furniture manufacturers can be very profitable. With this profitability comes some issues which need to be addressed by the company and its officers/shareholders. Is the company going to expand the production area, purchase the latest equipment on the market, or even make some dividend distributions? Because possible issues can exist, review the taxpayer's balance sheet, taxable income for the year, and the number of shareholders. If the taxable income is large and the company has: 1) substantial cash, investment assets, or nonbusiness assets; and 2) substantial amounts of retained earnings (which with adjustments, equates to earnings and profits as discussed in IRC section 312) one should review IRC sections 531 through 537, the IRM, and any outside publications to determine if a possible accumulated earnings tax issue exists before the initial appointment. Remember, an accumulated earnings tax issue will only apply to closely held corporations, therefore, this issue will not exist with a publicly traded company.

The reference sources listed previously should be reviewed before the first appointment because this may be the only opportunity for you to question the officer/shareholder directly. At this appointment, some of the required questions should be, what are the companies plans for the near future and how are they going to pay for these plans, have they made any large loans to outside vendors, and are any of their large clients in financial trouble. If the taxpayer has plans for expansion, they should be backed up with discussion in the board of directors minutes and contact with real estate brokers, equipment distributors, etc. In an accumulated earnings tax issue, the Government has hindsight because any plans the taxpayer has discussed previously should have been started or have been finished. The courts do not allow the taxpayer the opportunity to put off their plans indefinitely. The taxpayer must make a commitment to their plans and go forward with them. Finally, remember each accumulated earnings tax issue is different than the next because the facts and circumstances of each are different. What may have applied in one case, may not in the next.

### **Schedule M-1 and Schedule M-2**

There are two other schedules attached to the return which are intertwined with the balance sheet. They are Schedule M-1 and Schedule M-2. The main focus will be on the Schedule M-1, but a few brief comments will be made about the Schedule M-2.

The Schedule M-1 is used to convert the taxpayers book net income to the taxpayer's taxable income on the return. The accountant who prepares the return will eliminate items not allowed/required to be included in taxable income (that is, entertainment

expense and tax exempt interest). However, because of financial and time constraints the accountant may not make all the applicable adjustments necessary to convert book net income to the taxable income. Because of this, you should be inspecting for items required on the Schedule M-1, but not included.

Many taxpayers will keep their books on the cash method of accounting and at year end the accountant will make adjustments to put the taxpayer on the accrual method of accounting. If the accountant does not make these adjusting entries on the books, he or she will most likely make these adjustments in his or her work papers. Since no adjustments have been made to the taxpayer's financial statements, all the adjusting entries will appear on the Schedule M-1 either as an increase (accounts receivable) or decrease (accounts payable) to book net income. In all likelihood, the accountant will make most of the adjustments on the books, thus, the financial statements will be on the accrual method also.

When you are performing an audit of either the balance sheet or the income statement, remember the taxpayer can book personal expenses at their discretion, but there will only be an adjustment if a Schedule M-1 adjustment was not made or the personal expenses were not included on the shareholder's Form W-2. The tax treatment is different if the personal item is not being expensed. The corporation may have handled it correctly by classifying it as a dividend or a loan repayment. This can be verified by reviewing the Schedule M-2 or the loans to/from shareholder account.

If you determine the corporation took no position (that is, dividend, Form W-2) on the use or distribution of corporate assets, an adjustment will have to be made at the corporate level if the amount was expensed, along with an adjustment at the shareholder level for use of these assets under IRC section 301. Finally, in some cases, a distribution even though not expensed by the corporation (that is, distribution of appreciated property) can trigger income adjustments both at the corporate and individual levels, under IRC sections 311(b) and 301, respectively. In essence, the corporation will be treated as if it had sold the property to the shareholder at fair market value. The corporation will have to report a gain from the property on the difference between the fair market value and the adjusted basis. As for the shareholder, they will only have to report a dividend under IRC section 316 if the corporation has earnings and profits as computed under IRC section 312. In addition, if the shareholder assumes a liability attached to the property, this will reduce the dividend required to be reported by the shareholder (IRC section 301(a)(2)). If this issue is present, you will have to make an engineering referral requesting the assistance of an appraiser. Finally, if no earnings and profits exist, the distribution, either in the use of or the actual distribution of corporate assets, will first be allocated to a return of basis (capital) then the remainder will be considered capital gain (IRC section 301(c)).

Some of the more common adjustments you will find on the Schedule M-1 will be the

Federal income tax per book/return, entertainment disallowance under IRC section 274(n), depreciation adjustment for the difference between the book method and the tax method, officer's life insurance, the Unicap adjustment under IRC section 263A, state income taxes, fines and penalties, and charitable deductions.

The Schedule M-2, on smaller companies, will have minimal activity. The Schedule M-2 is used to reconcile the retained earnings account with any changes occurring during the year. Most adjustments are straight forward. You will see an adjustment for book net income, however, there may be other adjustments for prior period adjustments or distributions made either in cash, stock, or property. Be concerned with any prior period adjustments and how they were handled on the return filed for the year under audit. Were the prior period adjustments included in income or expensed in the year? Questions should be asked, and if necessary, adjustments proposed if these adjustments were not handled correctly.

Some audit techniques which can be used in determining whether a distribution has been made are:

1. During the initial review of the tax return, inspect Schedule M-2 for any reported distributions to the shareholders. Do not take the absence of entries of distributions at face value. The taxpayer may have improperly reported distributions. In addition, if a distribution is shown as being of property, ensure the provisions of IRC section 311 have been followed.
2. Reviewing the corporate minutes may reveal distributions of corporate assets to the shareholder. Trace these items to the Schedule M-2 and the Form 1040. If the minutes state a distribution was made and there is no entry on the Form M-2 or the Form 1040, question the discrepancy and if necessary propose an adjustment at the individual level, taking into consideration IRC section 312. If the distribution meets the conditions of IRC section 311(b), an adjustment at the corporate level may also be required.
3. Analysis of the year end journal entries will also reveal whether any distributions have been made and whether the taxpayer has expensed a distribution. In one case, the examiner noticed a journal entry explanation stating the property was "given" to the shareholder. This was written off by the corporation as a gift, without taking into consideration the limitations under IRC section 274(b). Naturally, this type of gift was in fact a distribution which was adjusted to reflect a dividend.

## Chapter 5

### SALES AND INCOME ISSUES

#### INTRODUCTION

The income analysis of the furniture manufacturing industry did not provide any single issue which was found to be common or prevalent throughout the market. On the contrary, there appeared to be a range of assorted income issues which an examiner may encounter. These issues ranged from simple unreported interest income to omitted sales. This section discusses those issues found in the study but you should be aware that many more potential income issues may exist which were not encountered in the returns examined.

During this study, the books and records used to account for income were not unique in nature. They included the usual sales, accounts receivables, cash receipts, and sometimes credit memo journals. In only one case was a factoring arrangement used to generate cash. In most cases, cash flow came directly from sales receipts and direct borrowings.

It should be noted the term "furniture manufacturer" included a broad range of products which at times were accounted for differently in regards to sales. For example, companies that produced "assembly line" goods such as sofas, chairs, inexpensive cabinets, etc., usually reported income when goods were shipped. Other companies, that produced custom furniture or commercial type furniture such as counters, shelves and racks, or large tables, may have accounted for sales on a modified percentage of completion method.

#### HOW SALES ARE GENERATED

One of the few consistencies found during this study were the methods used to generate sales. The primary methods encountered were:

1. Independent sales staff. Manufacturers used independent sales personnel more than any other method. Commission percentages ranged from 3 percent to 8 percent of gross sales generated.
2. In-house sales staff. This was less common than the independent sales personnel. The staff usually included shareholders and officers who traveled across the country keeping in touch with their retail customers.

3. Trade Shows. Like many manufacturing industries, trade shows are continually held across the United States and occasionally in foreign countries. Popular cities for trade shows include San Francisco, Dallas, and High Point, North Carolina.
4. Newspaper advertisements/mailers. In some cases, the manufacturer will work directly with the retailer in creating "mailers" which are distributed directly to the public. In most cases, the manufacturer's products are displayed along with their name. In all cases, the cost of the mailers were shared with the retailer and were regularly netted with the sales invoices.
5. Sales Marts. Some manufacturers maintain showrooms in Los Angeles, Dallas, San Francisco, etc. In these showrooms, the manufacturers will display their latest lines.
6. Word-of-Mouth. This was especially true for manufacturers involved with production of counter tops, tables, and other fixtures for banks, retail stores, and other commercial customers.
7. Public/Employee Sales. This accounted for a very small portion of sales generated.

## **GENERAL AUDIT TECHNIQUES**

### **Understanding the Sales Cycle**

As has been stated in other sections of this guide, the complex adjustments will usually result only if you understand the actual transactions along with the accounting systems. Sales analysis is no different. While a general understanding can be obtained during the initial interview, it is suggested an in-depth inquiry be made while you are auditing the specific sales accounts. Either way, the following inquiries are suggested:

1. Understand what the taxpayer sells. Ascertain what specific goods the taxpayer sells. For example, some manufacturers produce their own bedroom furniture such as bureaus but import the mirrors from overseas. If upholstered goods are produced, find out how many different lines are available. If old or current catalogs are available, request one to review and notate the various lines. In some cases, the taxpayer will also produce replacement parts for their own furniture which could make up a separate sales category. In other cases, the taxpayer may sell custom furniture.
2. Profit Margins. What type of profit margins are made on the furniture and how were they determined?

3. How are sales generated. Ascertain from the taxpayer whether independent sales personnel are enlisted or whether showrooms are used or any combination of the above mentioned methods.
4. Sales recording dates. Does the taxpayer record sales when the goods are shipped or when the customer acknowledges receipt of the goods? If the taxpayer produces custom style furniture, do they record income when the job is completed or do they record income on an interim basis when cash is received.
5. Discounts offered to customers. Find out whether cash, trade, volume, or any other discounts are offered or automatically taken by customers. The response to this question becomes especially crucial if the taxpayer accrues for discounts at the end of the year.
6. How are returns and allowances handled. Become familiar with the mechanics and bookkeeping involved with returns and allowances. For example, when a taxpayer is notified a product was damaged upon delivery or was the wrong product, who specifically handles the complaint. Is the complaint investigated right away, if at all? If the complaint is valid, who approves the return? Is a credit memo issued? Again, responses to these questions becomes crucial if the taxpayer accrues for returns and allowances at the end of the year.

### **Understand the Accounting System/Internal Controls**

Understanding the mechanics of the accounting systems and internal controls in effect may allow you to set the scope of the audit so maximum coverage is obtained in the least amount of time.

This goal is accomplished by relying upon the taxpayer's internal controls if they are effective in minimizing errors. Although this guide cannot go into the details of financial auditing, it is highly recommended that you become familiar with such audit steps as verifying sequentially numbered invoices, the handling of cash receipts, and segregation of duties.

### **SPECIFIC AUDIT TECHNIQUES**

#### **Internal Revenue Manual 4231-582**

During the course of the study, it was determined the audit guidelines established for gross receipts or sales in IRM 4231-582 along with the proper balance sheet analysis provided sufficient coverage in the income area. The IRM section is reprinted below for the reader's convenience with a few additional suggestions or observations. As stated previously, the applicability of the steps below should be considered in

conjunction with the evaluation of the taxpayer's internal controls.

**(1) In the initial testing of the sales account, the following techniques may be considered:**

**(a) Test methods of handling cash to see if all receipts are included in income. Scan daily cash reconciliations and related book entries and bank deposits. Note any undeposited cash receipts on hand at the end of the year.**

Note: Several errors were detected using this method whereby the original billing per the sales invoice did not match the subsequent cash receipts.

**(b) Test reported gross receipts by the gross profit ratio method. \* \* \***

**(c) Note items unusual in origin, nature, or amount in the books of original entry and test them by reference to original sales slips, contracts, job record book, bank deposits, etc. Also, check selected entries made at different times of the year, including some at the beginning of the year. Test check footings and postings to the general ledger.**

Note: In one case, the sales journal was scanned and a one-time sale was made to a company with almost the exact same name as the taxpayer. The follow up to this entry revealed a separate company which was related by common ownership. The entry was traced to the separate company where it was determined the shareholders were allocating income and expenses between the two companies to affect the taxable incomes. In this particular case, one company was doing very well and the other operated at a small loss. Therefore, in this case, the reporting of income by one and the expense by the other did not result in an equal increase and decrease in tax.

**(d) Review bank statements and deposit slips for unusual items. \* \* \***

Note: This step was discussed in Chapter 4, Balance Sheet, under Cash section.

**(e) Scan the sales account in the ledger for unusual entries. Test entries from the general journal and sales journal. Compare total receipts to total business income bank deposits and reconcile any differences.**

Note: In one case, the taxpayer was making large and consistent debit entries to the sales accounts. The original explanation was that the entries were returns and allowances. However, upon subsequent examination it was determined the debit entries represented customer checks that could not be processed because of insufficient funds. The bank would debit the taxpayer's account (credit entry on the taxpayer's books) and the taxpayer would debit sales rather than accounts receivables.

The taxpayer stated these entries were allowable under the bad debt provisions but could not refute the fact many of these accounts were collectible in the future.

**(f) Be alert to the possibility of income which may be taxable even though not appearing on the books (dealer reserve income, constructive receipt, income from foreign sources, etc.).**

**(2) If the results of these initial tests compare favorably with gross receipts reported, further verification would generally be based on the particular circumstances of the case. For example, a high percentage of cash receipts which are not regularly deposited or properly accounted for would be a basis for further testing.**

**(3) If further verification is necessary, the following techniques should be considered:**

**(a) If original receipts and records are not too numerous, match up invoices, contracts, or similar documents with any records kept by job or contract and reconcile any differences. If receipts and records are numerous, test check at various intervals and also look for unusual items. If possible, test quantities of the principal product sold in comparison with production or purchases. \* \* \***

Note: This step is especially pertinent with manufacturers who produce commercial products such as grocery counters, large shelves, or development projects. In most cases, the job must be bid for and a contract is drawn up. The examiner should be aware that supplemental contracts (also known as change orders) may be drawn up in special circumstances which should be included in income also.

**(b) Check the receipts to the sales or general journal and reconcile any differences.**

**(c) Question any unusual sales discounts or allowances.**

Note: See Chapter 5, for common discounts and allowances given.

**(d) Determine the extent to which receipts were used to pay operating expenses, liabilities, personal expenses, etc. \* \* \***

**(e) Determine the method and adequacy of accounting for merchandise withdrawn for personal use. Withdrawals should be accounted for as the merchandise is withdrawn and not on an estimated basis. Normally, purchases will be reduced by the cost of such merchandise; however, the amount may be credited to sales.**

**(f) If the taxpayer reports on the accrual basis, determine if all receivables are included in income.**

Note: Several timing adjustments were found by examining shipping

documents for sales booked in the subsequent year. These sales were erroneously booked in the next year. The materiality, corporate tax rates, and potential interest received should be considered before proposing the adjustments.

**(g) Scan sales agreements, contracts, and related correspondence for leads to unrecorded bonuses, awards, kickbacks, etc.**

**(h) If the records indicate contracts or sales may have been completed but corresponding income not reported, further inquiry should be made about the sales. If practical, check journal entries and bank deposits for the first few weeks of the following year to see if the amounts were taken into income at that time.**

**(i) Review work papers made for tax return purposes and make sure adjustments are appropriate. Reconcile receipts per books with receipts reported. Resolve any differences.**

Note: In some cases, the taxpayer was on the cash method per the books and made adjusting journal entries at the end of the year to arrive at the accrual method. These journal entries should be scrutinized carefully (especially the receivables and payables for both the beginning and ending of the year).

**(j) It may be necessary during the examination to secure additional records, documents, or other clarifying evidence. If such additional data will resolve matters, advise taxpayers of what is in question and the information needed. They should then be given an opportunity to furnish the information.**

Note: The examiner should not hesitate to utilize a summons if the records prove inadequate or the taxpayers unresponsive to requests. In one furniture case, it was necessary to summons not only the corporate bank records but the shareholders as well. The information revealed many unexplained deposits in the form of cashier checks and cash. Ninety percent of the cashier checks were under \$10,000 thereby avoiding currency transaction reports. These records, along with other corporate records obtained with a summons, were the basis for a criminal fraud referral.

**(k) Be alert to indications of:**

**1 Capital gain treatment of items which may constitute ordinary income.**

**2 Sales made or services rendered in exchange for other goods and services which were not included in income. [Bartering]**

**3 Unreported commissions or rentals from activities operated**

**on the taxpayer's business premises. In some cases, there may be arrangements for operating concessions or businesses such as cafes, bars, candy counters, vending machines, and newsstands.**

### **Other Recommended Income Probes**

1. Commission expense comparison. The commission expense can be used to extrapolate a sales figure for comparison with the sales reported on the return. For instance, if the majority of sales are generated through an independent sales force, the examiner can compute an average commission sales percentage. The commission expense, per the return, can then be divided by this percentage to arrive at an estimated sales figure. If there is a large discrepancy between the two amounts in either direction, ascertain the reasons why.
2. Request IDRS/CBRS information. Presently, certain transcripts are available which show Form 1099 information issued to corporations. Even though not required, some brokerage firms will issue Forms 1099-INT or 1099-DIV to corporate taxpayers. Examination of these transcripts (BMF) may reveal bank accounts not indicated in the books and records. Currency Transaction Reports may also indicate cash transactions which would lead to further inquiries.

### **OTHER INCOME ISSUES**

#### **Unreported Interest Income**

##### **Third Party Payments**

This issue was more prevalent in cases where there were weak internal controls. During the initial interview, question the taxpayer as to the number of bank accounts used and whether any of those accounts are interest bearing. As was discussed in Chapter 4, obtain the bank statements for the entire year and at least the year ending bank reconciliation if available. Any interest income entries found on the bank statements should be traced through a cash receipts journal or directly into an interest account in the general ledger.

##### **Related Party Payments**

In many cases, loans to shareholders were made for which no interest payments were made. If this is the case, then imputed interest to the corporation may be a possible issue under IRC section 7872 and the accompanying regulations. Of course, this may be an issue if the shareholders make interest free loans to the corporation as well. See the discussion in Chapter 4, under Loans to or from Shareholders for more detailed information.

## **Bargain Purchases Under IRC section 311(b)**

Although not encountered often, distributions of appreciated property under IRC section 311(b) produced significant income adjustments to the corporation as well as shareholders when raised. Although some work may be involved as far as determining fair market values (appraisals, comparisons, etc.) the adjustment is usually well worth the time.

Be aware of this issue whenever a sale of property has been made to a shareholder at an amount below fair market value. If these circumstances arise, IRC section 311(b) states income will be attributable to the distributing corporation AS IF such property were sold to the distributee at its fair market value.

For example, in one case, a building and land were distributed to three shareholders. On the Schedule M-2, a distribution to the shareholders was reported in the amount of \$20,000. The agent obtained an engineering appraisal of the building and land and determined the distribution was made at a value well below fair market value. Because of the difference in the appraised amount and the amount reported on the M-2, the agent was able to make the following adjustment to the corporation under IRC section 311(b):

FMV of Building/Land minus Adjusted Basis of Building/Land equals:

Amount attributed to Corporation as income

In this particular case, the difference between the two amounts produced a \$120,000 tax adjustment to the corporation. It should be noted, the distribution resulted in adjustments proposed to the shareholders' returns as well.

In another case, a classic automobile was sold by a corporation to a shareholder for \$20,000. At the time of the sale, the vehicle had been fully depreciated so that the adjusted basis was zero. The corporation reported the \$20,000 gain on its Form 1120. Research of Classic Car Guides revealed the fair market value was \$60,000. This resulted in an adjustment to the corporation of approximately \$40,000 as well as an adjustment to the shareholder's return.

Sales or distributions of property to shareholders may be discovered by analyzing the fixed assets schedule and notating any removals of assets since the beginning of the year. Be especially aware of vehicles dropping off the schedule. If sales are reported on Form 4797 of the Form 1120, ascertain to whom the sales were made. If the sales were made to shareholders or related parties, appraisals or contact with third parties should be considered to determine fair market values.

### **Lease Inclusion Income: Passenger Automobiles**

In 1984, IRC section 280F was enacted to provide limitations on the amount of recovery deductions allowed on "luxury" automobiles. Because leased automobiles did not fall under the provisions of IRC section 168 in terms of cost recovery, IRC section 280F(c) provided a limitation on the amount of lease deductions for passenger automobiles.

This provision does not provide for a limitation by reducing the lease deduction but rather requires the taxpayer to include a predetermined amount in their income. These predetermined amounts are based upon the fair market value of the leased vehicle as well as the term of the lease using tables provided by the Federal Government.

The regulations provide different tables depending upon what year the vehicle was first leased. Treas. Reg. section 1.280F-7 provides tables which cover vehicles leased after December 31, 1986, and before January 1, 1989. Rev. Proc. 89-64 provides for vehicles leased in calendar year 1989. Rev. Procs. 90-22, 91-30, and 92-43 provide the tables for the calendar years 1990, 1991, and 1992, respectively.

### **CONTRA)SALES ACCOUNTS**

The examination of sales should include a probe into the various contra sales accounts utilized by the taxpayer. These would include returns, various allowances, cash discounts, and other specialized reductions. In most cases, the furniture manufacturers had separate general ledger accounts for the various deductions. However, in a few cases, the return or allowance was deducted directly against the sales accounts. Trade and other discounts (such as volume discounts) are not properly treated as contra-sales accounts but instead should be reduced from invoice price in determining the cost of inventory under Treas. Reg. section 1.471-3(b). A taxpayer's treatment of trade and other discounts as a contra-sales/income account is an erroneous method of accounting, and any change from such accounting to the proper treatment as a reduction in invoice price is a change in method of accounting requiring consent of the commissioner. On the other hand, allowances such as cooperative advertising are not true trade discounts and thus are properly reflected in income accounts. Likewise, under Treas. Reg. section 1.471-3(b), cash discounts may be reduced from invoice price at the taxpayer's election, providing a consistent course is taken. Again, any change in treatment of cash discounts is a change in method of accounting. To familiarize the examiner, a few of the common returns, allowances, and discounts are discussed below.

## **Returns**

Depending upon the size of a manufacturer, returns may be a significant number. Returns were not found to be common with manufacturers who produced custom furniture. Mistakes made by the custom manufacturer will be corrected before delivery. On the other hand, returns are more significant for manufacturers who use an assembly line method. Customer returns are generated for several reasons including incorrect shipments, late delivery, or lack of funds.

## **Allowances in General**

Price concessions may be made for any particular reason depending upon the relationship with the customer. For example, in some cases, shipments may be delayed and arrive late. Customers who exert considerable influence may reduce the sales price by a "late" factor. Another allowance appearing to be common is an advertising allowance. Many of the large retail establishments such as Sears, Broadway, etc., will take out advertisements in newspapers and display the manufacturer's furniture. For this display, the retailer may deduct a certain portion from the sales price up to an amount agreed to by the manufacturer. This arrangement is referred to as cooperative advertising. In another situation, a large discount store deducted a 2 percent "defect allowance" for each shipment. Because of the influence large retailers exert, these allowances are rarely, if ever, protested.

## **Cash Discounts**

Discounts are sometimes given by the manufacturer for prompt payment by customers. These discounts may range from 2 to 4 percent depending upon the size and influence of the customer.

## **Accounting for Returns, Allowances, and Discounts**

Most manufacturers examined accounted for returns and allowances through a normal credit memo system. Whenever a return or discrepancy arose, the taxpayer would first verify the propriety of the return or allowance. For instance, any customer complaints about missing items would be crosschecked with the bills of lading and the shipping invoices. If the claim is valid, a credit memo will be issued to the customer usually to be applied against any subsequent sales.

The credit memos will usually be accounted for using some sort of journal. They are normally segregated together depending upon the type of return or allowance and a debit to the related general ledger account will be made. The credit will then reduce the accounts receivables.

## **Issues Encountered**

Issues are not usually raised with actual returns and allowances. However, many issues are generated because the taxpayer will attempt to use a reserve account or estimate the returns and allowances at year end.

For financial accounting purposes, reserves for estimated expenses such as returns and allowances or discounts based on past experience is an approved method of more accurately stating period income.

Such reserves are generally unallowable for tax accounting purposes having been abolished for most taxpayers by the Tax Reform Act of 1986 (with the bad debt reserve allowable in certain cases). Reserves for other estimated expenses have been repeatedly disallowed by the courts as not being specifically allowed for by the Code and failing to meet the all events tests for fixing liability.

The use of reserves for financial accounting purposes has been found in the furniture industry. In some cases, there may be a contra account called "Reserve for Returns and Allowances," "Allowance for Cash Discounts," or some other similar title which will be adjusted at year end as required. A balance sheet reconciliation may show it to be netted with the accounts receivable to arrive at the tax return balance. Journal entries at year end may then show increases or decreases to the reserve account with a corresponding increase or decrease to the returns or allowances accounts.

Alternately, and perhaps more frequently, adjusting journal entries are prepared at year end, debiting returns and allowances and crediting receivables directly, without the use of a reserve general ledger account. Such journal entries will be reversed whereas entries adjusting the reserve account will not. If an adjustment is made using this method, a reserve can be readily detected by inspection of the year end adjusting journal entries and the general ledger accounts, which will open with a large reversing journal entry and close with one or more large adjusting journal entries. A formidable reserve in the contra (Returns and Allowance) account may open the account with a large credit balance due to the posting of the reversal which is not erased until well into the year or close to year end.

A variation, on the preceding method, is to accrue subsequent returns or allowances by totaling credit memos issued in the months following the close of the fiscal year. Those deemed applicable to the prior year's sales are then accrued. Such accruals are of the same nature as a reserve, though they are not based on year end estimates, but rely on actual figures that are necessarily developed at a later date. The propriety of such accruals is based on the same criteria as is the propriety of any other reserve.

In one case, the taxpayer was following the financial accounting matching concept by accruing for cash discounts anticipated to be taken from the sales made during the last month of the taxable year. This accrual was computed by taking an historical percentage and multiplying against the last month's sales. This is a case where IRC section 461 was applicable and required the use of the all-events and economic performance test to determine whether this accrual was allowable for income tax purposes. The examiner disallowed the reserve amount by proposing an IRC section 481 adjustment.

There are, of course, many variations on the methods of accounting for reserves, but those outlined above are typical and knowledge of these formats should enable the examiner to detect the presence of a reserve.

If a reserve, on the books, is used for financial reporting purposes but not for tax purposes, an M-1 adjustment will be noted in conjunction with a deferred income tax account on the books.

## Chapter 6

### COST OF GOODS SOLD

#### INTRODUCTION

The Cost of Sales line on any tax return for furniture manufacturing will usually be the highest dollar deduction. The deduction will be computed based on the well known formula:

Beginning Inventory  
Plus Purchases  
Plus Labor  
Plus Other Costs  
(Less Ending Inventory)  
-----  
Equals Cost of Goods Sold

It has been determined, through this study, the majority of tax issues involve inventory. Issues ranged from omission of major segments such as finished goods (FG) and work-in-process (WIP) to recomputation of LIFO pools and indexes.

Although findings indicated inventory held the major issues, this should not preclude you from concentrating on the purchases, labor, and other cost components of the formula. On the contrary, issues were also found in these areas.

It is safe to say the Cost of Sales will take a great portion of the allocated audit time. It, therefore, behooves you to approach this section in an orderly and systematic fashion. This means you should have an audit plan which includes designated issues and methods to develop these issues. Each examiner has his or her own particular plan based upon issues encountered in the past. However, each plan should include the following considerations which are discussed in detail.

#### General Audit Techniques:

1. Understanding the production cycle
2. Understanding how the accounting system integrates the production cycle
3. Comparative Analysis
4. Reconciliations

## Specific Audit Techniques/Issues

- Testwork
- 1. Purchases
- 2. Cost of Labor
- 3. Other Costs & Deductions
- 4. Inventory

## **GENERAL AUDIT TECHNIQUES**

### **Understanding the Production Cycle**

The only evidence an examiner has available to make a determination will be documentation (manual or computer generated) or testimony from the taxpayer or officers. Simple issues can be easily determined by examining an invoice and verifying whether the invoice price matches the entry in the books.

However, more complex issues involve thought processes beyond invoice comparison. These issues may require an understanding of the production cycle not only for identification purposes but also for development purposes.

"Understanding" the production cycle does not mean determining how many staples are needed to attach fabric to a particular ottoman. Too much detail can produce diminishing returns. But just knowing the taxpayer produces sofas is insufficient. A solid understanding would include how production is planned, how far in advance raw materials are purchased, how raw materials are prepared for production, the assembly process, the time involved for assembly, the individuals in charge of each process, and so on.

### **Understanding Integration of Accounting System**

The next major step is understanding how production is manifested in the accounting records. This may range from simple purchase entries into the general ledger to more complex journal entries involving a standard cost system. Either way, the major entries must be understood.

Basic production steps such as raw material purchases usually flow through an accounts payable journal and then into the general ledger. Labor is recorded through a payroll journal and again into the general ledger. These processes should present no problems to you.

Other production steps may involve unique records not generally encountered in the course of a usual audit. For example, production planning or scheduling may be documented by something called scheduling sheets. These sheets may have the planned furniture lines, fabrics to be used, timetables for each department, and inventory identification numbers. These records could be useful in developing work-in-process amounts if omission of these segments becomes an issue.

Some manufacturers not only produce but import as well. Costing of these imports may involve documentation such as letters of credit, brokerage and duties invoices, and customs records. These documents could be very important in determining whether duties, insurance costs, and bank charges have been properly included in inventory.

The more sophisticated companies may use a standard cost system. In this case, it becomes essential to understand how the standard cost entries are integrated into the basic accounting system.

### **Comparative Analysis**

A comparison of costs over a two to three year period can highlight many unusual fluctuations. This comparative analysis should be performed as part of a normal package audit step when prior and subsequent years returns become available. The following steps are suggested to produce the most beneficial analysis:

1. Gross profit ratios. Comparison of the gross profit ratios over a 3-year period may reveal significant fluctuations. These fluctuations can be due to numerous reasons such as inventory write-downs, cost reclassifications, or simply bad management. Although an examiner may not identify the actual cause of fluctuations immediately, the comparison provides an indication serious analysis may be warranted.
2. Cost to cost comparisons. If 3 years of cost comparisons can be performed, it may pinpoint unusual fluctuations. This comparison should include all cost of sale accounts and not just direct costs. For instance, if an examiner notices an unusual increase in indirect labor costs with a decrease in employment taxes, it may indicate the taxpayer has converted employees to independent contractors.

### **Reconciliations**

The importance of reconciling the taxpayer's books to the tax return cannot be overemphasized. By reconciling all general ledger accounts, you will gain knowledge of: (1) the mechanics of the accounts, (some credit accounts may be classified with debit accounts and vice versa), (2) the numbering system and how it relates to the

specific areas of the tax return (sales may be 400 series, cost of sales 500 series, administrative 600 series, and miscellaneous 700 series), and (3) significant dollar accounts which need to be examined as opposed to insignificant accounts which may be passed.

## **SPECIFIC AUDIT TECHNIQUES**

### **Purchases**

#### **Journal Entry Analysis**

Before the selection of invoices to test, you may wish to survey the journal entries which enter into the various purchases accounts. Time should be taken to review the type and pattern of the entries. For example, the primary entry would probably be generated from an accounts payable or cash disbursement journal and this would be the primary focus of substantiation test work. Recurring journal entries made in addition to those generated from the normal journals should also be noted. Frequently, these entries represent various accruals, reclassifications, corrections, etc. At this point in time, it is not critical to know the exact nature of each journal entry but rather to recognize the pattern of the recurring entries and what appears to be normal and consistent. By recognizing normal and consistent entries, unusual entries may be highlighted for further analysis.

#### **Substantiation Testwork**

When invoices are selected for examination, several objectives having a direct or indirect effect on taxable income should be considered before actual test work is performed. Having these objectives in mind before audit work begins provides you with a focus and allows you to work efficiently and effectively.

1. Ordinary and Necessary. The first consideration will always be whether the criteria necessary for a business deduction has been met or whether it is of a personal nature or a capitalizable item.
2. Timing. If the deduction meets the ordinary and necessary criteria, does it relate to the current year or a subsequent year? In years of tax rate increases, this should always be a consideration. Test check purchases accrued at year end. Problems are mostly encountered with smaller closely held companies that do not have accounting controls. Accountants usually assume bookkeepers who prepare year end accruals know how to perform cut-off test work. This is not always the case.

Also, determine if any credit memos are outstanding at year end for returned purchases. These credit memos will be applied to the subsequent years purchases thereby producing an acceleration of deductions.

3. Allocations. An expense may meet the above criteria but may be incorrectly classified. For instance sales commissions may be improperly booked as an indirect production cost. Depending upon the magnitude, this may have a significant effect on certain allocation formulas utilized in the IRC section 263A regulations.
4. Confirmations. Purchases test work can provide evidence as to whether the taxpayer is properly counting and pricing ending inventory.
  - a. Test large dollar purchases at year end. Compare the purchases with year end inventory records. If a production cycle takes 3 weeks, purchases made in the last 2 weeks or so should be included in either raw materials or work-in-process. When this test is applied, comparisons may be made either with quantities or dollar amounts.
  - b. Select a variety of vendors to examine. This gives ranges of materials and prices. If invoices reveal #2 pine sells for between \$0.23 and \$0.30 per board foot, one would certainly be concerned with a major segment of #2 pine valued at \$0.10 per board foot on the inventory records.
5. Substance. Although not encountered often, some cases did involve related entities engaging in transactions between themselves. Issues to be aware of include: Pricing in excess of fair market value, excessive allowances, and the possibility goods and services were never delivered. The possibility of false invoices fraudulently inflating purchases should not be precluded. If questionable transactions are suspected, you must consider the possibility of auditing the related entity to determine the propriety of the transactions.

### **Cost of Labor**

The issues related to the labor portion of cost of sales do not usually involve substantiation issues. If not overly complex, a payroll reconciliation between employment tax returns and the corporate or partnership return may prove sufficient. A reconciliation should include wages and salaries as well as employment taxes deducted on the return. Reconciliations may raise independent contractor versus employee issues. Other issues may involve proper accruals for vacation and sick pay. The payroll reconciliation is discussed in more detail in Chapter 3.

## **Journal Entry Analysis**

Larger companies often accrue for vacation and sick pay. The accounting treatment is usually different for tax and book. As of 1988, the rules for accrual of vacation and sick pay have changed. Deductions for vacation and sick pay are limited to the amounts paid during the tax year, except an accrual-basis taxpayer may deduct unpaid vested vacation and sick leave pay if paid to the employee within 2 1/2 months after the end of the year. IRC section 404(a)(5) and Treas. Reg. section 1.404(b)-1T, Q & A.

For vacation pay to be deductible under IRC section 461, it must meet the All Events Test as well as the Economic Performance Test. For instance, for a company to deduct accrued vacation pay, economic performance must be established by: (1) the employees providing the services and (2) a liability must be established meaning the employee should be vested in the plan. If an employee does not meet the vesting requirements, no accrual may be deducted.

Since there are differences in the accounting treatment between book and tax, an adjustment should be present on the M-1 reconciliation schedule. If no such adjustment exists, analyze any vacation pay accruals. The following steps are suggested but by no means represent the only audit steps possible.

1. Determine basis for accrual per books. This can be based on a sophisticated formula, a simple estimate, or if the books are kept open long enough, the actual vacation/sick pay for the subsequent 2 1/2 months.
2. Request the company's policy on vacation/sick pay accrual. Determine how many years an employee must work for the company before vacation/sick pay has vested. Determine the basis for computation. It is usually based on number of hours worked during the year.
3. Check Year end Journal Entry. If the accrual seems unusual, you may wish to test the subsequent 2 1/2 month's payroll records for the vacation pay entries. Any large differences between the actual payment versus the accrual should raise questions about the propriety of the accrual.

## **Allocation of Production versus Non-Production Costs**

In cases where corporate officers are earning large salaries, you may wish to determine the primary capacity of the officers. (That is, sales, administrative, production, combination). This may be important in regards to the IRC section 263A allocation. If an officer's salary is primarily related to a single function, it can have significant impact on an allocation formula, especially the simplified production method.

## **Other Costs and Deductions**

Other costs and deductions usually involve production expenses such as indirect labor, rent, insurance, and other variable or fixed overhead costs. The same audit techniques applied to the purchases would also apply to Other Costs and Deductions.

## **INVENTORIES**

This study illustrated the majority of the issues for furniture manufacturing audits involved the inventory account. While this guide can provide insight into the more common issues, complex issues such as LIFO inventory valuations or standard cost variance analysis may require additional research beyond the scope of this guide.

When inventory is examined, keep the following points in mind whenever adjustments are considered:

1. If an adjustment to inventory is proposed and subsequent years have been filed, consistency dictates subsequent years should also be examined for the same issue. Therefore, if an issue involves a mathematical error or a miscount in inventory which would "roll" over to the next year, weigh several factors before proposing the adjustment and opening subsequent years. Considerations include materiality, changing tax rates, other inventory adjustments besides errors, time and effort required to open subsequent years, and the taxpayer's consistency in making errors.
2. An adjustment may involve a change in accounting method. Under Treas. Reg. section 1.446-1(e)(2)(ii)(a), a change in method of accounting includes a change in the treatment of any material item used in the overall plan of accounting for gross income and deductions. For furniture manufacturers, inventory is usually a material item. Therefore, if the adjustment proposed involves more than a simple correction of errors (that is, inventory valuation by write downs, no IRC section 263A costs applied), be aware of any rule or regulation related to changes in accounting methods (that is, IRC section 481, Rev. Proc. 92-20, etc.).

The following steps are recommended to begin the inventory audit.

### **Determine How the Inventory Amount Was Arrived**

One of the first initial interview questions regarding inventory should be whether the taxpayer took a physical inventory. The second question should be whether the taxpayer actually counted the items on hand. In several cases, taxpayers inspected their inventory but estimated either the actual quantities on hand or the relative dollar amounts. Although the experience of the taxpayer may allow him or her to perform this accurately, you may need to expand the scope of test work to verify this.

### **Determine All Possible Locations of Inventory**

During the initial interview and tour of the business, notate all possible locations of inventory. This would include additional warehouses, showrooms both on and off the premises, and additional factories. If the taxpayer operates a Maquiladora, this location should be considered as an inventory site.

### **Obtain Ending Inventory Records**

If possible, obtain all pertinent inventory records. This would include:

1. Inventory Summary Sheets. These show totals for general categories such as raw materials, work-in-process, finished goods, goods-in-transit, and goods-on-consignment. Once records have been obtained, foot the schedules and agree the total to the return. If the total does not reconcile, ascertain the reasons. Possibilities may include market write-downs, IRC section 263A additions, errors, etc.
2. Physical Count Sheets. These can be voluminous depending upon the size of the inventory but obtain a complete set if possible. These records are very important because they provide information regarding specific types of raw materials, actual counts, pricing, and product lines. These records should be checked for mathematical accuracy on a sample basis by footing and extending. Note any items with unusual and low priced values (\$10.00 when other items are priced with odd figures such as \$105.45) or crossed out values being replaced with lower or zero valuations.
3. Cost Sheets. These may be requested (if available) if valuation issues arise such as proper use of the full absorption method, IRC section 263A or lower of cost or market method. Potential information includes breakdowns of particular pieces or lines of furniture in terms of raw materials (type, quantity, and cost), labor (hours per item, rates per hour, total dollar per item), and any overhead allocations (specific costs, overhead rates).
4. Burden Computations/263A Unicap Computations. This will probably be provided by the accountant and could possibly show costs used in the allocation and methods used for allocation to ending inventory.

### **Journal Entry Analysis**

In most cases, general ledger inventory accounts will not have much activity during the year. Analyze any year end journal entries which reduce inventory and increase cost of sales. In one case, an inventory write-down was made in this fashion.

## **ISSUES**

Inventory issues in the furniture industry fell into two primary categories: Incorrect inventory counts/omissions and improper valuations. Identification and development of these issues will directly depend on the existence and quality of the inventory records. Identification of issues may not be very difficult (taxpayer tells you they estimate their final inventory) but development (figuring out what a proper inventory dollar amount is reasonable) will require ingenuity, creativity, and plain sweat to finally resolve the issue.

### **Incorrect Inventory Counts/Omissions**

Under Treas. Reg. section 1.471-1, inventory includes all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. Another requirement is the merchandise should be included in the inventory only if title thereto is vested in the taxpayer.

#### **Purchases**

In most cases, raw materials are purchased locally and can be delivered in a matter of days or even hours. However, in some cases, raw materials may be purchased from foreign countries and take several weeks for delivery. Taxpayers will often times miss including these goods in their physical counts. In other cases, the taxpayer will "forget" to count certain items.

### **Finished Goods Imported From Overseas**

Payments are usually made via letters of credit and delivery often takes several weeks. These goods-in-transit may be excluded at year end.

#### **Goods on Consignment/Sample Pieces**

Goods are often held by sales representatives on consignment. Showrooms will often house large selections of inventory for public or commercial viewing. Sometimes these pieces are neglected in the inventory count.

#### **Return Items**

If a dispute arises with a customer which can only be resolved by returning the goods to the taxpayer, be aware these goods should be added back to inventory.

## **Work-in-Process/Finished Goods Not Counted**

In several cases, the taxpayer did not include work-in-process and finished goods in the ending inventory count. They mistakenly believed fast turnaround times for completion, delivery, and entry into sales did not require them to count the goods as inventory.

## **Material Supplies**

Items such as wood legs and arm pieces, veneer pieces, boxes, nails, staples, wrapping, and other incidental supplies while not significant alone can become a substantial dollar amount when combined. These items may be excluded from ending inventory if they are believed to be incidental or "too hard to count."

## **Audit Techniques**

1. Year end Cut-Offs. This can be performed in conjunction with the purchases test work. Select some of the major purchases made at the end of the year for raw materials. If the production cycle is documented, delivery times for raw materials should be one of the questions. Know the times it takes for receipt of materials, the cycle of the production process, and final conversion into finished goods.

Compare major purchase invoices with physical count sheets for the raw materials. In some cases, material may be directly traceable due to similar descriptions on the invoice and count sheets. In other cases, you may need to use all factors such as material quantity, description, and dollar amounts, both price per unit, and total dollar to determine whether a particular purchase was included in the count.

For example, lumber, fabric, and foam are primary purchases for upholstered goods. Lumber is usually measured by foot or meter dimensions such as 2-1/2 x 8-1/2 and is priced in terms of board feet/meters. Foam is also described in terms of dimension but is sometimes priced by either dimensions or weight. Fabric is measured in terms of yardage and is priced accordingly. Use of all these factors may be necessary to reconcile invoices with the count sheets.

2. Letter of Credit (LC) Analysis. In several cases, the taxpayer imported tables from China and used a customs broker to handle the payment of duties and other import fees. In most cases, an LC arrangement was made with a domestic bank to arrange a transfer of funds to the overseas vendor. LC's are simply short term loans against an established line of credit.

Although it is highly probable, purchases made overseas are handled differently than the following narrative, it will be discussed as it appeared the most frequently.

Title will vest to the purchaser depending upon the specific arrangement with the overseas agent and is based upon who accepts risk of loss or damage during shipping. In some cases, the purchaser will accept the risk when the goods leave the vendor (FOB Origination) or when the goods have reached the domestic port (FOB Destination). It is up to you to determine each individual case. Each specific purchase of inventory is usually designated as a "container" and an LC is set up separately for each container. Each LC is identifiable by a specific number provided by the domestic bank handling the transaction.

LC's will normally appear with the short term notes payables section of the balance sheet. If possible, obtain a breakdown of the LC's and request documentation such as the brokerage statements behind each LC. Once the information has been obtained, you can compare the LC's which were booked into purchases with the inventory records to determine whether they were included.

3. Goods on Consignment/Sales Samples. Identification of issues may be accomplished with a simple initial interview question regarding showrooms and locations along with the existence of show pieces and then a comparison with the ending inventory records.
4. Returned Items. Check the year end journal entries for accruals of approved returns which may not be in the possession of the manufacturer. If they are proper accruals, they should be included in inventory at their respective cost.
5. Omitted WIP/FG. If these segments are missing, computation of reasonable amounts can be performed with sufficient information. The following situation is an example of arriving at such an amount.

During the initial interview, the taxpayer has stated a sale will be recorded when goods have been shipped and acknowledged with a customer signature on the bill of lading. Technically speaking, you can then look at the subsequent years sales along with the bills of lading and determine which goods were shipped before or on the last day of the year and should have been included in ending inventory. This will establish the number of units. How do you establish a dollar figure?

At this point, it is up to your creativity to arrive at a reasonable number. The number should be based on information gathered from the taxpayer about the company if possible. For example, in the initial interview, the shareholder has stated he tries for a 100 percent mark-up on cost. Therefore, the cost is estimated to be 50 percent of sales price. Take the total sales price of the above estimated units and multiply by 50 percent and you have a starting inventory number for finished goods.

In some cases, taxpayers have been willing to take a current physical inventory. Of course, a current physical inventory has no bearing on the accuracy of the cost of sales for the year of audit due to the 2 or 3 year time lag. However, having an accurate physical count provides basis for computation of a true gross profit percentage using current year information. This may allow you to extrapolate the percentage back to the years of audit if factors are reasonably similar.

6. Incidental Supplies. Although manufacturers often times include the value of the incidental supplies in the costing of their finished goods, they do not always include the supplies still available at year end in the physical count.

A means of estimating the portion that should be inventoried separately is to make an assumption that the incidental supplies remain in ending inventory in the same proportion major materials (lumber, foams, fabrics, etc.) bear to the total purchases of major materials during the year. The formula can then be applied as follows:

$$\frac{\text{Ending inventory major materials}}{\text{Total purchases of major materials}} = N\%$$

$$N \% \times \text{Total incidental supplies} = \text{Ending incidental supplies to be inventoried}$$

## **Improper Valuations**

### **No Freight Addition to Raw Materials**

Treas. Reg. section 1.471-3 states inventories at cost should include the invoice price of such goods less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the goods.

The materiality of this addition will depend upon where the raw materials are obtained and how much effort is required to deliver the materials.

### **Imported Goods**

Costs incurred to import from overseas include:

1. Letter of Credit Charge. This is the actual cost of the tables.
2. Letter of Credit Processing Fees. Cost of setting up letter of credit, wire transfers, etc.

3. Shipping Freight Charges and Import Duties.
4. Insurance Costs. Although these costs will vary, it is safe to say costs incurred to bring the goods from overseas range between 6 to 10 percent of the letter of credit charges. When you encounter imported goods, be aware of these additional charges for inventory purposes.

### **Inventory Write-Down Under the Lower of Cost Or Market Method**

Since most production in the furniture industry is geared towards specific orders rather than particular inventory levels, excess goods were not found to be common. However, the issue was encountered a few times so you should be aware of the possibility.

Rule of Law: Treas. Reg. section 1.471-4 provides the rules that govern when inventory may be reduced to the lower of cost or market. Be aware of the most significant guidelines of the regulation:

1. "Market" means the current bid price prevailing at the date of inventory for the particular merchandise in the volume in which usually purchased by the taxpayer. This rule applies to both finished goods as well as raw materials. The "current bid price" has usually been defined by the courts. (See **Thor Power Tool Co. v. Commission**) as the replacement cost of the goods.
2. Where no open market exists or where quotations are nominal, the taxpayer must use such evidence of a fair market price at the date or dates nearest the physical inventory count. This means the taxpayer should provide evidence such as a sale of the particular or similar item or show the item was placed on the market at a lower price than cost. If this burden has been met, the taxpayer may value the specific inventory item at the lower price less any costs of disposition. The correctness of the prices will be determined by reference to actual sales for a reasonable period before and after the date of inventory.
3. When the lower of cost or market method is applied, the market value of each ARTICLE on hand at the inventory date shall be compared with the cost of the ARTICLE, and the lower of such values shall be taken as the inventory value of the ARTICLE. Therefore, this rule precludes a manufacturer from taking a general write-down on a combination of raw materials as well as finished goods, or on several different lines of furniture without providing evidence of the fair market value for each specific item.

## **Audit Techniques**

1. **Freight Valuations on Raw Materials.** Evaluate the inventory summary and determine if any freight additions have been made via a percentage mark-up. Taxpayers often simplify computations with a general percentage addition to the entire raw material amount.

If no such mark-up exists, a comparison can be made between selected purchase invoices and the physical count sheets. Freight costs will vary significantly depending upon vendor location.

2. **Imported Goods.** Obtain the back-up documentation behind a specific Letter of Credit (Custom Brokerage Statements, Duty Statements, etc.) and make an analytical comparison with the count sheets for any imported goods. Because of fluctuations in currency rates, the various costs may change but an average percentage mark-up for each container can be computed and applied to the imported goods inventory. The recomputed costs can then be compared with inventory records.
3. **Inventory Write-Downs.** Write-downs of inventory may be found anywhere ranging from the detailed inventory records to the accountant's trial balances. Therefore, the auditor should be aware of the following:
  - a. Obtain and review the inventory summaries which contain the totals for raw materials, work-in-process, and finished goods. Many times a write down shows up as a single entry at the bottom of the inventory category as a percentage or dollar reduction.
  - b. Be aware of selected categories of inventory items. For example, finished goods may be categorized by location in the plant of the manufacturer or in a separate warehouse. The furniture at the warehouse may be hard to sell items whose value has been decreased.
  - c. On the detailed inventory records which show the counts, prices, and extension, be aware of prices having been crossed out and replaced with lower values. Check goods valued at even prices and those appearing to be significantly lower than other similar items. For instance, a newer line of sofas may be valued at \$173.78 per item. Another line may be valued at \$100 or lower. This may indicate a writedown was taken in a previous year.
  - d. If the taxpayer has kept old price lists related to the year of audit, request these lists. Although they will probably be the wholesale or retail prices and not cost, they may provide a comparison of relative value if the taxpayer uses consistent mark-ups.

- e. If the taxpayer has a showroom, determine if these items have been included in the inventory count or valued at significantly lower amounts than normal.
- f. Manufacturers may have physical counts of goods with zero values. These should be questioned as to the reasoning behind these values.

### **UNIFORM CAPITALIZATION RULES: IRC SECTION 263A FOR TAX YEARS ENDING BEFORE JANUARY 1, 1994**

The Tax Reform Act of 1986 established IRC section 263A which generally states certain direct and indirect costs should be capitalized in the case of certain tangible property which included inventory. This Code section worked in conjunction with the Full Absorption Method of inventory accounting for manufacturers as stated in Treas. Reg. section 1.471-11.

Despite the fact this specific regulation has been in effect for some time, it has proven to be one of the primary issues involving inventory. Either taxpayers choose to ignore the regulations entirely or they assume any overhead allocation previously made is sufficient to satisfy the requirements.

This section covers the basics of IRC section 263A allocations and provides you with the basic formulas available to either compute an allocation or to test the reasonableness of the taxpayer's own method.

In the majority of cases, a furniture manufacturer will fall under the purview of IRC section 263A. Certain exceptions involving long-term contracts and goods for resale may apply and if this occurs then further research may be required.

Treas. Reg. section 1.263A-1T(a)(1) states, "all costs that are incurred with respect to real or tangible personal property which is produced, or property which is acquired for resale, are to be capitalized with respect to such property." The term "produce" includes construction, building, installing, manufacturing, developing, improving, creating, raising, or growing.

The costs that must be capitalized in the ending inventory include all direct costs, all indirect costs associated with production, and costs which are not required to be capitalized.

#### **All Direct Costs**

This includes direct material costs and direct labor costs. Direct material costs are defined as those which become an integral part of the subject matter and the cost of those materials consumed in the ordinary course of the activity. Direct labor costs

include the cost of labor which can be identified or associated with a particular activity. The primary direct labor costs will include items such as basic compensation, overtime pay, vacation and holiday pay, sick leave, and employment taxes.

### **All Indirect Costs Associated with Production**

Indirect costs are defined as those costs other than direct costs which are associated with the performance of a production or resale activity. It is important for you to note that certain indirect costs are still associated 100 percent with production such as a production supervisor's wages, employment taxes, and fringe benefits related to production. Other indirect costs, such as computer costs used to generate both purchases and sales journals, are only partly associated with production and must be allocated either using the 90 percent de minimis rule, the simplified methods as provided by the regulations, or by another reasonable method allowed the taxpayer. Primary indirect costs cited by the regulations which must be considered include:

1. Repair and Maintenance of equipment or facilities.
2. Utilities.
3. Rent of equipment, facilities, or land.
4. Indirect labor and contract supervisory wages.
5. Indirect materials and supplies.
6. Tools and equipment the costs of which are not otherwise capitalized.
7. Quality control/inspection.
8. Taxes (not including federal, state, or local income taxes) relating to labor, materials, supplies, equipment, land or facilities. This does not include taxes incurred by the taxpayer to acquire depreciable property and included in the basis of the property (that is, sales taxes).
9. Depreciation, amortization and cost recovery allowance on equipment and facilities.
10. Administrative costs whether or not performed on a job-site, but not including any cost of selling or any return on capital. For example, a portion of salary costs incurred by the accounts payable department should be capitalized as part of the IRC section 263A costs.

11. Direct and indirect costs incurred by any administrative, service, or support function or department (that is, allocable computer costs, telephone, etc.).
12. Officer's compensation attributable to services performed in connection with particular production or administrative activities.
13. Insurance, such as insurance on plant, machinery or equipment, or insurance on products or worker's compensation insurance.
14. Contributions paid to or under a stock bonus, pension, profit-sharing or annuity plan, or other plan deferring the receipt of compensation whether or not the plan qualifies under IRC section 401(a) and other employee benefit expenses paid or accrued on behalf of labor.
15. Rework labor, scrap, and spoilage.
16. Bidding expenses incurred in the solicitation of contracts ultimately awarded to the taxpayer. In several cases, a taxpayer's product was the building and installation of tables, counters, desks, and shelves for large retail establishments. These retail companies required submission of bids by the taxpayers.
17. Engineering and design expenses.
18. Costs incurred for storage and warehousing, purchasing, handling, processing, assembling, and repackaging and the portion of general and administrative costs allocable to these functions.

### **Costs Which Are Not Required to be Capitalized**

Cost which are not required to be capitalized include:

1. Marketing, selling, advertising, and distribution expenses.
2. Bidding expenses incurred in solicitation of contracts not awarded to the taxpayer.
3. General and administrative expenses and compensation paid to officers attributable to the performance of services that do not directly benefit or are not incurred by reason of a particular production activity. Therefore, such items as the salary for the VP of Sales, the costs solely associated with the accounts receivables department, or the administrative costs associated with those departments are not required to be capitalized.
4. Research and experimental expenses as defined by IRC section 174.

5. Losses under IRC section 165 and regulations thereunder.
6. Depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle.
7. Income Taxes.
8. Contributions to a pension plan to the extent such contributions represent past service costs.
9. Cost attributable to strikes.
10. Repair expenses that do not relate to the manufacture, or production of property.

**Audit Techniques**

1. Understand How Ending Inventory is Valued. During the course of an initial interview you will ask the taxpayer and the representative the question -- Are IRC section 263A costs allocated to the ending inventory? The representative will answer with an authoritative "of course" and point to the tax return to show you they have segregated the IRC section 263A costs in the Schedule A of the Cost of Sales section. Many times the Schedule A will show the following:

Schedule A Cost of Goods Sold or Operations (See instructions).

Inventory at beginning of year	150,000
Purchases	1,200,000
Cost of Labor	750,000
Additional IRC section 263A costs	60,000
Other costs (Statement 5)	65,500
Total - Add lines 1 through 4	2,225,500
Inventory at end of year	175,000
	-----
Cost of goods sold and/or operations	2,050,500
	=====

Statement 5 - Other Costs

Pension Services	10,000
Accounting and Legal	15,000
Automotive Expenses	7,500
Office Supplies & Expenses	20,000
Officer's Expenses 15,000	
Telephone	8,000
Various Other Expenses	50,000
Less: Amount of Other Costs included in cost of sales as IRC section 263A Costs	(60,000)
	-----
Total Other Deductions	65,500
	=====

Of course this schedule shows nothing as far as what costs have been allocated to ENDING INVENTORY. The only way to determine whether an allocation has

been made is to understand how the taxpayer has costed the ending inventory. Therefore, request the following records, if not requested previously:

- a. Inventory records for work-in-process and finished goods. Sometimes, the overhead allocation is made right on the summary sheets as a straight percentage computation.
  - b. Request any cost sheets the taxpayer may have which break down the cost allocation into materials, labor, overhead, etc.
  - c. Obtain accountant's inventory work papers showing any IRC section 263A computations made.
2. Computing the IRC section 263A allocation. If the taxpayer has made an allocation, how does one determine if the computation is reasonable? Or, if no IRC section 263A allocation has been made, how can that be corrected?

Treas. Reg. section 1.263A-1T(b)(5) has provided a simplified method of accounting for production costs which can be used to determine whether the taxpayer's method is reasonable or it can be used if no allocation was made at all. This method may be used in conjunction with the simplified method for allocating mixed service costs as provided by Treas. Reg. section 1.263A-1T(b)(6).

Before the simplified methods can be applied some preliminary steps must be performed. These steps are listed as follows:

- a. The costs previously allocated to ending inventory must be determined. These are termed as "IRC section 471" costs in the regulations. This will usually include at least the direct materials and direct labor and possibly an additional overhead allocation. In many cases, it is simpler to readjust the taxpayer's ending inventory figures to include just the direct materials and direct labor amounts. This will be demonstrated later.
- b. Then segregate all costs into the following categories:
  - 1) Direct Production
  - 2) Indirect Production
  - 3) Indirect Mixed Service costs
  - 4) Non-related production (sales related, administrative related to overall policy making etc.)

5) Interest expense and income taxes (Federal/State/Local).

In segregating the costs, determine whether the de minimis rule per Treas. Reg. section 1.263A-1T(b)(6)(iv) is applicable. This rule is used in conjunction with the mixed service cost formula and is used to determine whether a cost should be treated solely as a production or a non-production cost. The general rule states, "a service cost shall be treated as solely allocable to a particular activity if 90 percent or more of that cost directly benefits or is incurred by reason of such activity. In such a case, 100 percent of such costs shall be treated as allocable to such activity." For example, if it is determined a company's shipping department activities are broken into 90 percent shipping duties and 10 percent receiving duties (incoming purchases), then the entire cost of the shipping costs (wages) should be segregated to the non-production category.

Any other service cost which does not meet the de minimis rule should be placed in the mixed service cost category for future allocation.

If the taxpayer uses accounting methods which are different for book purposes than tax, use the costs generated by the tax method. For example, if the taxpayer uses the straight line method of depreciation for book and MACRS for the tax return, the costs computed under MACRS should be used. Also, any costs excluded from deduction due to statutory limitations (20 percent entertainment rule, charitable deductions, etc.) will be excluded from the computations. If adjustments are proposed to expense accounts, then the corrected numbers should be used. Therefore, if an adjustment is made to repairs and maintenance for capitalization of production equipment, the adjusted repairs and maintenance amount should be used along with the adjusted depreciation expense amount which will include the reclassified equipment.

3. Allocation of Mixed Service Costs. Determine what percentage of the mixed service costs are required IRC section 263A costs. This may be accomplished using the Simplified Service Cost Method per Treas. Reg. section 1.263A-1T(b)(6). Once the costs have been segregated, it is a relatively simple allocation formula because it uses the taxpayer's own cost numbers as the basis. The formula is as follows:

$$\begin{array}{l} \text{Total} \\ \text{Mixed Service} \\ \text{Costs} \end{array} \times \frac{\begin{array}{l} \text{Total Production Costs} \\ \text{For the year} \end{array} *}{\begin{array}{l} \text{Total of All Costs} \\ \text{For the year} \end{array} @} = \begin{array}{l} \text{Portion of mixed} \\ \text{service costs} \\ \text{allocable to} \\ \text{production} \end{array}$$

Footnotes:

\* = Amount excludes mixed service costs and interest. Includes the direct production and indirect production costs listed previously.

@ = Amount includes all costs (production and non-production) except those categorized by the examiner as mixed service costs, interest, and Federal/State/Local income taxes.

See also Notice 88-86, 1988-2 C.B. 401, and Treas. Reg. section 1.263A-1(h)(3)(ii).

4. Computation of Absorption Ratio. Then proceed with the allocation of the indirect production costs and production related mixed service costs. This can be accomplished through the Simplified Production Method as stated in Treas. Reg. section 1.263A-1T(b)(5). The formula is similar to the mixed service cost method in it relies upon the taxpayer's own numbers for the allocation method. The formula is as follows:

$$\begin{aligned}
 & \text{a) } \frac{\text{Total IRC section 263A Costs \#}}{\text{Total IRC section 471 Costs}} = \text{Absorption Ratio} \\
 & \text{b) } \text{Absorption Ratio} \times \text{Production costs in ending inventory} = \\
 & \quad \text{Portion of IRC section 263A cost to ending inventory}
 \end{aligned}$$

Footnotes:

# = Amount includes allocated mixed service costs plus allocated indirect production costs.

The regulations define the IRC section 471 costs as those which were included in inventory under the taxpayer's method of accounting immediately prior to the effective date of the section.

If the taxpayer has only included direct materials and direct labor in their ending inventory computation, this does not present a problem. The denominator simply becomes all the direct material and direct labor costs after adjustments.

However, in many of the cases examined, a percentage such as 10 percent of the direct material or direct labor, was added as an "overhead burden" factor. The question then raised is which additional costs should be included in the denominator of the formula.

In this situation, the choice made was to simply eliminate the overhead factor and assume all inventory (IRC section 471) costs were simply direct materials and direct labor. This had the result of computing an absorption ratio which was theoretically too high. The ratio was compensated for by reducing the final adjustment by the overhead percentage factor.

**Example 1**

263A Costs: \$ 300,000

Ending Inventory:

WIP	50,000 (Material/labor)
F/G	100,000 (Material/labor)
Overhead	10,000 (10% of F/G)
	-----
Total End	160,000
	=====

Total IRC section 471 costs for the entire year:

Materials	2,000,000
Labor	1,000,000
	-----
Total	3,000,000
	=====

Simplified Production Method:

263A costs:	300,000	
	-----	= 10% (absorption ratio)
471 costs:	3,000,000	

IRC section 263A Cost added to ending inventory:

WIP/Finished Goods:	150,000 x 10% = 15,000
Less Amount already included:	(10,000)
	-----
Final Proposed addition	5,000
	=====

One word of caution. In using the procedures prescribed by the regulations (simplified service method and production method), the bottom line percentage used to allocate IRC section 263A costs gets filtered and manipulated through a sequence of computations. It is highly recommended that the laptop computers be used to shorten computation time. By being able to recompute a IRC section 263A allocation percentage at a moments notice, you will be able to determine whether it would be necessary to argue that 60 percent rather than 40 percent of an officer's salary should be allocated as an indirect cost.

5. Application of Simplified Production/Service Cost Methods.

**Example 2**

Let us say the taxpayer's final inventory consists of finished goods and work-in-process in the following amounts:

Finished Goods.....	198,000
Work-in-process.....	60,679
	-----
Total ending inventory.....	258,679
	=====

The examiner has determined the IRC section 471 costs consists of only direct materials, direct wages, and certain indirect production costs which have been accepted as correct.

The examiner has determined the simplified production and service cost methods will be used for the IRC section 263A allocation. It should be noted other allocation formulas are available in the Regulations if those formulas reasonably allocate the indirect costs.

The first step required is to segregate the tax return costs into production costs already allocated into inventory ("471 Costs"), direct and indirect production costs not allocated into ending inventory, mixed service costs (MSC), non-production costs, and excluded items such as interest, income taxes, etc.

The breakdown of the costs are as follows:

	<u>Total</u>	<u>Prod.</u>	<u>MSC</u>	<u>Prod.</u>	<u>Other</u>
1. Direct Material	576,183	576,183*			
2. Direct Labor	672,985	672,985*			
3. Freight-in/Shipping	8,537	8,537*			
-----	-----	-----	-----	-----	-----
Direct Production Costs	1,257,705	1,257,705	0	0	0
4. Insurance - Workers Comp.	83,210	83,210*			
5. Indirect Labor(O/S)	113,968	113,968*			
6. Payroll Taxes	157,408	111,760*	45,648		
7. Rent	186,000	186,000*			
8. Repairs/Maintenance	21,951	21,951*			
9. Shop Supplies	15,678	15,678*			
10. Utilities	37,619	37,619*			
11. Depreciation-Sch. A	26,912	26,912*			
12. Equipment Rental	61,391	61,391*			
-----	-----	-----	-----	-----	-----
Indirect Production Costs	704,137	658,489	45,648	0	0
13. Officer Compensation	196,000	98,000+	68,600	29,400	
14. Salaries	81,397		81,397		
15. Bad Debts	12,333			12,333	
16. Taxes(Not incl FIT/SIT)	3,451	2,933+	518		
17. Depreciation	11,534		11,534		
18. Advertising	15,732			15,732	
19. Accounting	8,482		8,482		
20. Auto	24,318	8,268+	8,025	8,025	
21. Bank Service Charges	1,396		1,396		
22. Commissions	145,978			145,978	
23. Delivery	8,996			8,996	
24. Entert(After 20% Reduct)	15,361		4,608	10,753	
25. Insurance	19,718	10,845+	5,915	2,958	
26. Legal & Professional	15,881		15,881		
27. Miscellaneous	1,278		1,278		
28. Office Supplies	20,061		20,061		
29. Telephone	27,856	5,571+	13,928	8,357	
30. Trade Shows	23,313			23,313	
31. Travel	13,602			13,602	
32. Utilities	1,318		1,318		
33. Interest Expense	43,512				43,512
34. State Income Taxes	7,500				7,500
35. Federal Income Taxes	13,992				13,992
-----	-----	-----	-----	-----	-----
G&A Costs	713,009	125,617	242,941	279,447	65,004
-----	-----	-----	-----	-----	-----
Total Costs:	2,674,851	2,041,811	288,589	279,447	65,004
=====	=====	=====	=====	=====	=====

Footnotes:

\* = IRC Section 471 costs (Previously allocated to inventory) = \$1,916,194  
 + = production related costs not in ending inventory = \$ 125,617

The above amounts include all adjustments being proposed by the examiner.

1. For PRODUCTION RELATED COSTS, segregate all direct and indirect costs already included in inventory (IRC section 471 Costs) and those not included in inventory (Allocable IRC section 263A costs).

Production Costs allocated into ending inventory: 1,916,194  
 Production Costs not allocated into ending inventory: 125,617

2. Segregate the remaining costs into those which benefit both production and nonproduction departments (MIXED SERVICE COSTS) and those that only benefit the nonproduction departments. Exclude interest and income taxes from the allocations.

Mixed Service Costs: 288,589  
 Non-Production Costs: 279,447

3. The examiner must now determine how much of the mixed service costs should be allocated to production. This may be accomplished in several ways. The examiner may isolate the administrative costs and through interviews with the taxpayer allocate a different percentage based on hours or salaries related to production versus nonproduction. However, a simple method is through the use of the Simplified Service cost method as defined previously. Using the above numbers the allocated IRC section 263A mixed service costs is computed as follows:

$$\begin{array}{r}
 1,257,705 + 658,489 + 125,617 \text{ (Production Related)} \\
 \hline
 253,847 \\
 2,674,851 - 65,004 - 288,589 \text{ (Total Expenses less} \\
 \quad \text{Interest, Income Taxes, \& Mixed Service Costs)}
 \end{array}
 \quad \times \quad 288,589 =$$

Therefore, 253,847 will be considered production related mixed service costs or IRC section 263A costs.

4. The next step is to apply the Simplified Production Method as defined previously and compute the absorption ratio using the computed IRC section 263A costs and the total IRC section 471 costs as follows:
- a. IRC section 263A production costs allocation:

$$\begin{array}{r}
 \text{Indirect Production Costs requiring allocation:} \quad 125,617 \\
 \text{Mixed Service Costs requiring allocation:} \quad 253,847 \\
 \hline
 379,464 \\
 \text{=====}
 \end{array}$$

- b. Absorption Ratio:

$$\begin{array}{r}
 \text{263A Costs:} \quad 379,464 \\
 \hline
 \text{471 Costs:} \quad 1,916,194
 \end{array}
 \quad = \quad 19.80\%$$

5. Compute the IRC section 263A allocation to ending inventory:

$$\begin{array}{r}
 \text{IRC section 471 Ending Inventory:} \quad 258,679 \\
 \text{Absorption Ratio:} \quad \times .198 \\
 \hline
 \text{Addition to Ending Inventory:} \quad 51,218 \\
 \text{=====}
 \end{array}$$

### **IRC SECTION 263A REGULATIONS: POST 1993**

New and modified rules were issued which took the form of final regulations under IRC section 263A (Final Treas. Regs. section 1.263A-1 through 3). In the case of property that is inventory in the hands of the taxpayer, these sections are effective for taxable years beginning after December 31, 1993.

The final regulations made changes to both goods held for inventory and for resale. Because the modifications are too numerous to list, a few of the changes or clarifications relating to manufacturers in general are highlighted below:

1. The uniform capitalization rules do not apply to inventories valued at market under either the market method or the lower of cost or market method if the market valuation used by the taxpayer generally equals the property's fair market value. For this purpose, the term "fair market value" means the price at which the taxpayer sells its inventory to its customers less, if applicable, the direct cost of

disposing of the inventory. However, the uniform capitalization rules do apply in determining the market value of any inventory for which market is determined with reference to replacement cost or reproduction cost.

2. IRC section 263A rules will not apply to producers who have total indirect costs of \$200,000 or less. A de minimis rule treats these producers as having no additional IRC section 263A costs for purposes of the simplified production method.
3. The new regulations added several additional costs which are not required to be capitalized. These include IRC section 179 costs and warranty and product liability costs.
4. The new regulations now allow the use of a historic absorption ratio rather than the taxpayer having to recompute a ratio year after year.

### **LIFO INVENTORY VALUATION**

During this study, the LIFO method was encountered in a few situations. Since explanation of LIFO methods would involve an entire manual, it is suggested if a LIFO method is encountered, IRS training guides (Training Guide 3127B, LIFO Method of Inventory Valuation, Rev. 12-87) or other supplemental manuals be obtained. A few steps might be performed while researching the issue:

1. Taxpayer must make a proper election: Whenever the taxpayer utilizes the LIFO method per IRC section 472, a proper election must be attached to the return for the year the LIFO method is first elected. The application may be made on the Form 970 or on a separate schedule prepared by the taxpayer which provides the necessary details.

Therefore, if the taxpayer is on the LIFO method, request the original election form for review. This form should state which particular method will be utilized (Unit versus Dollar-Value), whether different pools will be used, and the specific method for computation of the dollar-value indexes (Double extension, producer price index, etc.)

2. Financial Reporting Requirements: For the taxpayer to use the LIFO method, the taxpayer must establish no method other than LIFO has been used in his or her report or statement of income, profit, or loss to shareholders, partners, other proprietors, beneficiaries, or for credit purposes.

During certain unfavorable economic conditions, the taxpayer may seek termination of the LIFO method using this violation. It is up to you to review the

financial statements for the inventory method utilized and to make a determination whether any violation of the financial statement requirement was made intentionally.

If a certified audit has been performed, obtain a copy of the balance sheet and footnotes to determine what inventory method has been used for financial statement presentation.

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## Chapter 7

### CHANGE IN ACCOUNTING METHOD

#### INTRODUCTION

Because inventory adjustments are not uncommon in the furniture manufacturing industry, you will find it necessary to become acquainted with procedures for making a change in accounting method. Examples of changes in accounting method for inventory include revaluations due to IRC section 263A, changes from the cost to lower of cost or market method, and changes from a FIFO to LIFO method or vice versa. With the issuance of Rev. Proc. 92-20, one must also consider the possibility of allowing the taxpayer to spread the adjustment over several years.

#### WHAT IS A CHANGE IN ACCOUNTING METHOD?

Treas. Reg. section 1.446 defines parameters for a change in accounting method. In most cases, the regulation defines a change in a negative fashion, that is, what is not a change in accounting method (correction of errors, changes of any item of income or deduction which does not involve the proper time for inclusion, etc.). Treas. Reg. section 1.446-1(e)(2)(ii)(c) states, "A change in an overall plan or system of identifying or valuing items in inventory is a change in accounting method. Also, a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in accounting method."

So based on the regulations, a change in accounting method would not include corrections of errors made during a physical count or while totaling the final inventory summary. It would include adjustments to add freight costs to raw materials, to include IRC section 263A costs in inventory, or to revalue a segment of inventory improperly written down under the Lower of Cost or Market Method.

Examiners may be confused because the adjustment is often viewed as "rolling over" to the next tax period. They conclude any tax increase resulting from the year of audit would be given back in the next year. This judgment may be true with correction of errors although consistent errors throughout the years can still result in overall adjustments in the Government's favor. In the end, this judgment may also be true for a change in accounting method depending upon the fluctuations in the inventory balances over the years or the existence of net operating losses. The point to be made, however, is you should not let this argument dissuade you from investigating and

developing an issue. Only by determining the consistency and the magnitude of an inventory issue will you know the true tax effect of the adjustments.

### **IRC SECTION 481 ADJUSTMENT**

IRC section 481 was enacted to prevent amounts from being duplicated or omitted when a change in accounting method is made. Under normal circumstances, a taxpayer makes a voluntary change by filing a Form 3115 requesting permission to change and to possibly spread any increase in taxable income over a number of years to avoid a distortion of income. In an audit situation, the taxpayer's options may be limited or curtailed altogether, depending upon the type of adjustment. In both cases, the IRC section 481 adjustment must be segregated from what is termed the "current year" adjustment to allow for potentially different treatment.

IRC section 481 addresses both the amount of adjustment and the tax effect of that adjustment. IRC section 481(a) addresses the adjustment to taxable income while IRC section 481(b) limits the amount of tax that may be assessed due to the change in accounting method.

For purposes of this guide, it is assumed any adjustments resulting from changes in accounting methods are those proposed by you under an audit situation. Be aware, however, that different treatment of a IRC section 481(a) adjustment may be accorded the taxpayer even under an audit situation depending upon the category of the change. To this end, it is recommended you study Rev. Proc. 92-20 and understand the various situations you may encounter regarding a change in accounting method.

### **How IRC Section 481 Interacts With an Inventory Adjustment**

When a change in accounting method is proposed for inventory, you must be aware of the effects on both the beginning and ending inventories. For example, if IRC section 263A costs have not been properly allocated to inventory, remember both the beginning and ending inventories are lacking allocations. Therefore, consistency dictates adjustments include both beginning and ending inventory amounts. This consistency requirement generates two separate tax adjustments. One is termed the "current year adjustment;" the other is considered the IRC section 481(a) adjustment. The distinction must be made because each may be taxed differently depending upon the available options allowed by the Code, regulations, and revenue procedures.

As inventory is a balance sheet account, any proposed adjustments will affect the cost of sales computation and eventually taxable income. To simplify discussions in this guide, any changes in inventory will be assumed to directly affect taxable income (T.I.) with no mention being made of the intermediate effect on cost of sales. Therefore,

keep the following in mind throughout the chapter:

Inventory Adjusted	Adjustment	Effect on COGS	Effect on T.I.
Beginning	Increase	Increase	Decrease
Beginning	Decrease	Decrease	Increase
Ending	Increase	Decrease	Increase
Ending	Decrease	Increase	Decrease

For purposes of illustration, assume you are proposing an IRC section 263A adjustment. After adjusting beginning and ending inventories to include proper IRC section 263A allocations for a particular year, the IRC section 481(a) adjustment is the difference between the beginning inventory as adjusted and the beginning inventory as originally stated. The current year adjustment is the difference between the restated beginning and ending inventories. The current year adjustment can either be positive or negative depending upon the relative sizes of the beginning and ending inventories.

**Example 1**

An adjustment is proposed to a manufacturer who never previously allocated IRC section 263A costs to ending inventories. The year of audit is calendar year 9012 and the entity is a corporation. The beginning of the year, IRC section 263A addition, has been computed at \$30,000 while the ending of the year addition has been computed at \$40,000.

	<u>Per Return</u>	<u>263A Adjust.</u>	<u>Revised</u>
Begin. Inventory @ 1/1/90	50,000	30,000	80,000
Purchases	100,000		100,000
Labor	<u>100,000</u>		<u>100,000</u>
Cost of Goods Available for Sale	250,000		280,000
Less: Ending Inventory @ 12/31/90	<u>50,000</u>	<u>40,000</u>	<u>90,000</u>
Cost of Sales	200,000		190,000
	=====		=====

Since the cost of sales has decreased, a positive adjustment of \$10,000 is proposed to taxable income for the 9012 year. This is the current year adjustment. As previously stated, this is the difference between the restated beginning and ending inventories (\$80,000 and \$90,000). Note, if the adjustments had been reversed, there would have been a negative tax adjustment of \$10,000.

Since the taxpayer has been given credit for the \$30,000 increase in beginning inventory, IRC section 481(a) prevents receipt of benefits from the duplication of expenses. In this particular case, the taxpayer is considered to have received benefits from the addition to beginning inventory in 1990 and by excluding these additional costs from ending inventory in previous years. Therefore, the \$30,000

will also be included in taxable income as the IRC section 481(a) adjustment to prevent duplication.

It should be noted in order for the Service to be consistent in its position, subsequent years should be audited (with group manager's approval) and adjustments proposed for the same issue. The subsequent year's adjustments will be considered current year adjustments and will be taxed in the respective years.

By studying the above example, you may conclude it is easier and shorter to simply adjust the ending inventory by \$40,000 and include everything as a current year adjustment. Under certain circumstances, this will be allowable and preferable. Under other circumstances, however, you must compute the IRC section 481(a) adjustment since it may be accorded different tax treatment as discussed in the next section.

### **IRC Section 481(b)(1) and (2) Limitations**

Once the IRC section 481(a) adjustment has been computed, your first consideration is whether the adjustment can be made all in one year. Notices and Revenue Procedures have been published which mandate certain IRC section 481(a) adjustments be made entirely in the year of change. (See Rev. Proc. 92-20, 1992-1 C.B. 685.) If the taxpayer is precluded from spreading the IRC section 481(a) adjustment forward, you must consider the tax limitation of IRC section 481(b).

IRC section 481(b) provides a limitation in the amount of tax a IRC section 481(a) adjustment can generate. It is designed to provide relief to taxpayers who have graduated into higher tax brackets over the years while maintaining the particular method of accounting. Taxation of the entire IRC section 481(a) adjustment in a single year at a higher tax bracket was considered unfair since the adjustment could have been taxed at lower rates had the proper accounting method been in effect. This limitation is created by allocating the adjustment over prior years and computing the resulting increase in tax. It should be noted that prior years returns are not opened and the limitation per IRC section 481(b) is different than the methods provided for in Rev. Proc. 92-20.

Before IRC section 481(b) is applicable, several criteria must be met. The first is the IRC section 481(a) adjustment must increase taxable income for the year of change by more than \$3,000. The second is the same method previously used by the taxpayer was in effect for the previous years the limitation is considered.

If the above criteria have been met, then the following steps should be taken in computing the limitation in tax:

1. Compute the tax solely associated with the IRC section 481 adjustment. The first step is to compute the increase in tax for the year of change which is attributable solely to the adjustments required under IRC section 481(a) and Treas. Reg.

section 1.481-1. This increase will be the difference between the tax computed by making the IRC section 481(a) adjustment over the tax computed without making the IRC section 481(a) adjustment. If there are non-IRC section 481 adjustments being proposed, the tax computed on these adjustments must be calculated prior to taking into consideration any IRC section 481(a) adjustments. Once this is performed, this new taxable income will be the starting point in determining the tax on the IRC section 481(a) adjustments.

2. Compute the tax under IRC section 481(b)(1) -- 3-year allocation spread. In this step, the IRC section 481(a) adjustment is equally allocated to the year of change and the 2 preceding taxable years. The increase in tax attributable to the allocation in each such taxable year is the difference between the tax for such year computed with the allocation and the tax as originally stated. Each years increase is added together to arrive at the total increase attributable to the IRC section 481(a) adjustment.
3. Compute the tax under IRC section 481(b)(2) -- Prior years allocation. If the taxpayer can establish from his or her books and records what his or her taxable income would have been under the new method of accounting for one or more consecutive taxable years immediately preceding the taxable year of change AND the old method has been consistently applied for those consecutive years, then the IRC section 481(b)(2) limitation must also be considered. The total increase in tax due to the IRC section 481(a) adjustment will be the sum of each years tax difference computed as follows:
  - a. Tax computed under the new method of accounting, less
  - b. Tax as originally stated in the return

Per the regulations, in using the IRC section 481(b)(2) method, any IRC section 481 adjustment not accounted for by the prior year's recomputations, is retained in the year of change.

If the taxpayer meets the above criteria, the limitation on the tax is the smallest of the three computations stated above. It should be noted that IRC section 481(c) and the accompanying regulations provide for certain circumstances such as net operating losses or capital loss carrybacks or carryforwards.

**Example 2**

Using the information from Example 1 the examiner is also proposing T & E adjustments of \$5,000 and omitted interest income of \$3,000 for the 9012 year.

Step 1: Compute tax solely associated with IRC section 481(a) adjustment for the 9012 year.

	-----	Tax -----
Taxable Income per return:	\$60,000	\$10,000
Non-481(a) Adjustments:		
- T&E	5,000	
- Interest Income	3,000	
- Cost of Sales (Current year Adj)	10,000	
	-----	
Taxable income before 481(a) adj	\$78,000	14,770
IRC 481(a) adjustment:	30,000	
	-----	
Taxable income with 481(a) adj:	108,000	25,370
	=====	
Increase in tax due to 481 adj:	\$10,600	(25,370-14,770)
	=====	

Note: Tax is computed with current year adjustment included.

Step 2: Compute tax solely associated with IRC 481(a) using a 3-year allocation method.

	8812		8912		9012
	T.I.	Tax		T.I.	Tax   T.I.
	Tax		T.I.	Tax	T.I.
	Tax		T.I.	Tax	T.I.
	Tax		T.I.	Tax	T.I.
Amounts as originally filed					
or as adjusted:	30,000	4,500		55,000	8,750   78,000 14,770
IRC section 481(a) allocation					
(30,000/3)	10,000			10,000	
Recomputed T.I. & Tax	40,000	6,000		65,000	11,250   88,000 18,170
		-----			-----
Increase in tax		1,500			2,500   3,400
Total increase:	7,400				
	=====				

Step 3: The taxpayer states he or she can recompute his or her taxable income under the new method for the years 8712, 8812, and 8912 and does so. Because the business was started in 1987, the beginning inventory starts at zero. The beginning and ending inventories are restated as follows.

	8712	8812	8912	9012
Beg Inv. as originally stated	0	30,000	25,000	50,000
Ending Inv. as originally stated	30,000	25,000	50,000	50,000
263A adjustment				
- Beg Inv.	0	11,500	9,000	30,000
- Ending Inv.	11,500	9,000	30,000	40,000
263A adjustment, as computed	11,500	(2,500)	21,000	10,000
Beg Inv. as corrected	0	41,500	34,000	80,000
Ending Inv. as corrected	41,500	34,000	80,000	90,000
Net effect on T.I.	11,500	(2,500)	21,000	10,000
T.I., as original stated	25,000	30,000	55,000	78,000
T.I., revised	36,500	27,500	76,000	88,000
Tax, revised	5,646	4,125	14,090	18,170
Tax before 481(a)	3,750	4,500	8,501	4,770
Net Tax Effect	1,896	( 375)	5,340	3,400
Total Tax Increase	10,261			
	=====			

Step 4: The Change in accounting method will therefore result in the smallest of the three net changes above. The tax adjustment resulting from the IRC section 481 adjustment will, therefore, be limited to \$7,400.

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## Chapter 8

### MAQUILADORAS

#### INTRODUCTION

Many problems associated with manufacturing furniture in California have prompted manufacturers to find new ways of doing business. Some of these problems are inherent in the system, such as the South Coast Air Quality Management District (SCAQMD), the high cost of workers compensation insurance, and the high labor cost. To avoid these problems and to stay competitive in the world market, furniture manufacturer(s) are moving their operations south of the U.S./Mexico border. They establish subsidiaries under Mexico's Maquiladora Program which are commonly referred to as "twin plants," or in Spanish, maquiladoras.

Begun in 1966 in response to the United States' elimination of its Bracero Program, Mexico's Maquiladora program was created to encourage U.S. and other non-Mexican enterprises to establish manufacturing facilities in Mexico. By participating in this program, furniture manufacturers are able to take advantage of the lower cost of labor, plant, and equipment, as well as the relaxed regulatory requirements in Mexico. In addition, raw materials, supplies and production equipment may be imported into Mexico free of all duties while title is retained by the U.S. owner. The savings on labor cost alone is enough to justify the move south. In the furniture industry, Mexican workers are paid around \$5 per day including benefits, while their counterpart(s) in the United States are paid from \$7 per hour, plus benefits. In addition, the maquiladora is not required to have workers compensation insurance on the Mexican workers and the environmental laws are more relaxed.

This manual is not intended as a complete guide for the Maquiladora industry. Rather, it devotes this section to highlight areas in the furniture manufacturing industry which may require assistance from an International Agent. To request assistance from an International Agent, submit a Form 2962 to an International group in your district. However, if you have questions concerning the maquiladora industry, you can contact the Maquiladora ISP directly (currently the ISP works for the Southwest Region and is based in San Antonio, Texas). Contact your district MSSP coordinator for any changes. In addition, the ISP has requested a survey form be submitted for each Maquiladora case being audited. (See Exhibit 8-1 at the end of the chapter.)

The Maquiladora ISP recommends a thorough examination of any case(s) which involves a new maquiladora operation(s), a maquiladora operation which has been sold/discontinued, a maquiladora which sells its production in Mexico, or a

maquiladora owned by a foreign controlled corporation (FCC) which sells to or buys from its foreign parent. Mexico applies transfer pricing rules to maquiladoras beginning in 1994 which would make most maquiladora operations profitable, therefore, increasing their audit potential.

There are many issues related to maquiladoras, but before you can find them they must be able to identify a maquiladora operation. Therefore, a brief discussion on how to identify maquiladoras will be presented first, followed by a discussion of each significant issue.

## **IDENTIFICATION**

A maquiladora may be identified if a Form 5471, Information Return with Respect to a Foreign Corporation, is filed with the tax return. However, this form has to be reviewed to determine whether the Mexican company had a profit/loss for the year. Since maquiladora's are cost centers, their profit margins are very small. Per the agreement with the Mexican Government, they must make between a 1 percent to 6 percent profit. Therefore, if the profits of the Mexican subsidiary are greater than 6 percent or there is a loss, there is a possibility the company is not a maquiladora but instead is a PITEEX. A PITEEX is a company which is not a cost center but a profit center. The disadvantage of being a maquiladora instead of a PITEEX is all of the finished products assembled in Mexico must be shipped back to the United States unless permission is granted by the Mexican Government to sell within the country. A PITEEX on the other hand is allowed to sell their product within Mexico.

A cost center is a company set up to manufacture a product and the costs incurred to produce the product are reimbursed by the parent. This arrangement is not a true arms length transaction because there is no profit motive. A profit center, on the other hand, is an arrangement which is a true arms length transaction. The profit center will submit a bid for manufacturing the product, and in this bid there will be a built-in profit. Since the company is competing against other manufacturers, they may be awarded the contract or they may not.

If a Form 5471 is not attached to the return and the examiner has a feeling the taxpayer owns a maquiladora, contact the ISP asking for his or her assistance in researching through his or her records whether the taxpayer does in fact own a maquiladora. The ISP has at his or her disposal records (that is, customs records, outside publications, etc.) which can assist in determining if the taxpayer does in fact own a maquiladora.

Some indications which can key you into a possible maquiladora are: 1) checks being written for large round dollar amounts payable to the taxpayer or to cash. When conducting business in Mexico, the maquiladora pays all the workers in cash, thus

large round checks being written to the taxpayer or to cash; 2) checks being cashed at towns bordering Mexico; 3) shipping documents showing shipments being delivered to Mexico or a border town; and 4) expenses for customhouse brokers.

## **ISSUES**

### **U.S. Assets Used by the Maquiladora**

When a U.S. taxpayer (parent) sets up a Maquiladora, they will provide all the equipment needed in the manufacturing process. The equipment is usually owned by the U.S. company because of an asset tax in Mexico. The asset tax is 2 percent of the value of the assets owned by the Maquiladora, therefore, if the U.S. company owns the equipment and leases it to the Maquiladora there is no asset tax due. The issue with this arrangement is the method of depreciation the taxpayer is using for the equipment. Under IRC section 168(g), the U.S. taxpayer is precluded from using an accelerated method of depreciation for property used predominantly outside the United States. They are required to use the alternative depreciation system (ADS).

The other problem with depreciable assets is the transaction may not be at arms length. Many times the parent will claim depreciation on assets but will not recognize any income. This may be due to no lease payments being made or the income not being reported by the parent. You may want to impute lease payments on the equipment or a disallowance of the expenses associated with this equipment. Therefore, a decision should be made on how this issue will be handled. There will be further discussion on how the expense side can be handled under IRC sections 482 and 1059A.

### **IRC Section 482 - Allocation of Income and Deductions Among Taxpayers and IRC Section 1059A - Limitation on Taxpayer's Basis or Inventory Cost in Property Imported from Related Persons**

You should only concern yourself if the expenses of the Maquiladora are being paid by the parent and are dutiable by U.S. Customs. When costs are incurred in Mexico, the U.S. Customs will require a tariff rate be paid on the value added in Mexico. This value added is what is referred to as dutiable. If the expenses being paid on behalf of the Maquiladora are nondutiable, you will not have an issue with these Code sections. Therefore, do not spend time figuring out the amounts which should have been allocated to the Maquiladora. Instead, look at the domestic side of the issue for possible adjustments (that is, IRC sections 162, 263A).

When the parent sets up a Maquiladora, they must treat it as a separate unrelated entity even though they own the company. The parent will provide the raw materials and all the supplies necessary for the production, while the Maquiladora will provide the processing. The parent will be billed for all the direct expenses, overhead

expenses, and a small profit as required by the Maquiladora agreement. Many times the parent will pay some of the expenses on behalf of the Maquiladora and write them off on their books. These expenses will not appear on the Maquiladora's books, therefore, most likely they will not appear on the duty reports when the goods are returned to the parent. Since the duty amount is based on the value added in Mexico, the parent has avoided paying duties by paying for the expense themselves. In addition, the Mexican Government has also lost out on tax revenue. Customs has the authority to audit the books of the Maquiladora to determine whether the correct amounts have been declared, but they will be limited if the expenses do not appear on the books.

Try to reconcile the payments made to the Maquiladora to the Form 5471, Custom Reports (Form 247), and the budgets prepared by the Maquiladora. The budgets and the customs reports should be reviewed to determine exactly what expenses are being included. By performing this comparison, you will be able to determine if additional amounts were sent down to Mexico to cover expenses which were not included in the customs reports. If there are differences, you should question these because they may be dutiable costs or amounts not necessary for the production process. If unable to reconcile and it looks suspicious, the examiner/international agent can make a referral for an exchange of information using the tax information exchange agreement with Mexico. By making this request, the examiner/international agent can secure a copy of the return filed in Mexico and from this determine what kind of expenses have been incurred by the Mexican subsidiary.

If during an audit of a taxpayer, you find out the expenses are being paid by the parent, the examiner/international agent will have to allocate the correct amounts between the parent and the Maquiladora. After this allocation, the examiner/international agent will have to determine what expenses are dutiable and whether duties have been paid on these amounts. If the taxpayer has failed to include costs paid by them directly in the customs declaration and it is determined the costs are dutiable, an IRC section 482 adjustment will have to be made. By making this IRC section 482 adjustment, you will disallow the expense on the taxpayer's books as not being an ordinary and necessary expense of the corporation. The taxpayer may argue they could have paid the Maquiladora directly for the expense, therefore, the adjustment would be a wash. However, if this expense was not taken into consideration when the value added was declared, duties were never paid on the amount disallowed. If the U.S. Customs were to audit the maquiladora's books, this dutiable expense would not appear on the books because the taxpayer has paid for this expense on behalf of the maquiladora. Therefore, Customs would not make any adjustments to the amount which should have been dutiable. Customs has not been paid the correct duties and the taxpayer has incurred expenses which are not theirs.

To avoid this situation, adjustments proposed under IRC section 482 will not be allowed a correlative adjustment because of IRC section 1059A. To illustrate IRC sections 482 and 1059A, the following is an example.

**Example 1**

If the taxpayer had paid the utilities on behalf of the maquiladora and the examiner/international agent disallowed this amount because it was not an ordinary and necessary expense of the taxpayer, the taxpayer would not be allowed an increase in their cost of sales account for the same amount. Usually, when a IRC section 482 adjustment is made, there will be a balance between the adjustments (that is, interest expense and interest income) therefore, a decrease in utilities would be offset by an increase in the cost of sales. Since the product is being imported back into the United States, IRC section 1059A does not apply this principle, but instead states if the amount was not declared for Customs purposes, the taxpayer will not be allowed to increase their inventory by the same amount. Therefore, the taxpayer classifying the expense as utilities and then saying it is a wash would only apply if the correct duties were paid. The taxpayer cannot later come back and say the expense should have been a cost of sales item instead. The bottom line is if the taxpayer failed to pay duties on the value added, they will pay income tax on the amount which they have paid on behalf of the Maquiladora.

This adjustment sounds very easy to find and propose, however, there is a problem the IRS has no control over. What is considered dutiable by Customs is determined by generally accepted accounting principles in Mexico and at this time Customs has not attempted to determine what should be included in this amount. Therefore, IRS is reluctant to test a customs issue in Tax Court.

**Shelter Operations**

If a U.S. company does not have the capital, the experience, or the manufacturing volume to operate a Maquiladora, but they want to participate in the program, they can contract out to a shelter operator. A shelter operator will manufacturer the product for the taxpayer according to their specifications. A shelter operator can own their own shop or they can contract out to other companies in Mexico for the manufacturing process. The transactions between the United States and the shelter operator will be at arms-length, therefore, no IRC section 482 issues will exist. However, there may be an issue between the U.S. shelter operator company and the Maquiladora. From a case a team member audited, it was found the U.S. shelter operators are usually close to the Mexican border. Since the shelter operator can be a U.S. entity, a possible Form 1099 issue may exist if one was not issued. Therefore, if this setup is found to exist, inquire further about the shelter operator to determine if the operator has filed a return. If necessary, a collateral examination should be initiated for a possible nonfiler or underreported income issue.

### **Foreign Corporations - IRC Section 1504(d) Election**

This Code section provides that a domestic corporation may elect to include a wholly owned subsidiary incorporated in a contiguous country (Mexico or Canada) in the consolidated return group if such wholly-owned subsidiary is maintained solely for the purpose of complying with the laws of such country as to title and operation of property. The Service's position on whether a Mexican subsidiary formed as part of the Maquiladora industry maintained solely for the purposes of complying with the laws of Mexico as to title and operation of property was considered by the IRS in G.C.M. 38119 (October 1, 1979) and P.L.R. 8125143 (March 27, 1981), and the answer to the question was in the negative. Cases in process are still in the development stages.

**Exhibit 8-1**

Mail to:  
Internal Revenue Service  
5835 Callaghan Rd. Stop 4350SANW  
San Antonio, TX 78228  
Attn: Maquiladora ISP

Attachment

**ISP - Maquiladora Issues Survey**

Region: \_\_\_\_\_ District No.: \_\_\_\_\_ Group No.: \_\_\_\_\_

Taxpayer's Name  
(Parent): \_\_\_\_\_

Maquiladora  
Name(s): \_\_\_\_\_

Year(s) Under  
Examination: \_\_\_\_\_

EIN (Key Case): \_\_\_\_\_ Address (Key Case): \_\_\_\_\_  
(Use Label)

Case/Group  
Manager: \_\_\_\_\_

Phone No.: \_\_\_\_\_  
Address: \_\_\_\_\_

Revenue Agent/Team Coord.: \_\_\_\_\_

On-site Phone No.: \_\_\_\_\_

	<b>Debt/Equity</b>			
Issue:	<u>Swap</u>	<u>482</u>	<u>1504(d)</u>	<u>1059A</u>
Adjustment (potential):	\$ _____	\$ _____	\$ _____	\$ _____

Percentage Completed (Circle One): 25 50 75 100 Other \_\_\_\_\_

Estimated Completion Date: \_\_\_\_\_

Is Maquiladora ISP assistance requested: Yes \_\_\_\_\_ No \_\_\_\_\_

Comments (Status of examination, Other Maquiladora issues  
(Please describe and prepare attachments as needed))

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Please submit copies of Forms 5471, 5701, and 886A for  
Maquiladora Issues.

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## Chapter 9

### EXPENSES

#### INTRODUCTION

In addition to a thorough examination of the balance sheet, scrutinize the expense deductions found on a tax return. The areas discussed below are those where team members found substantial adjustments or items particular to the furniture manufacturing industry. Specific examination issues may require further research. To this end, references are made to various sources of information.

In the discussions that follow, the writer has referred to items being classified as constructive dividends. However, the taxpayer must have sufficient earnings and profits as computed under IRC section 312. Otherwise, the distribution will have to be classified differently, that is, return of capital, then capital gain.

#### ADVERTISING

Advertising for furniture manufacturers includes word of mouth, newspapers and other print, showrooms, trade shows, and factory representatives. In general, the type of advertising varies depending on the type of customer.

In the examination of this account, you need to be watchful for misclassified expenses. In many cases, entertainment and meals expenses, subject to the deductibility limitations under IRC section 274(n), were included in the advertising account and the limitation was not applied to these amounts. In addition, one team member noted that donations and gifts were classified to the advertising account.

#### Catalog Costs

It is the IRS position that catalog costs, for which benefits extend beyond one year, are to be capitalized and depreciated over the useful life of the catalog. The IRS position is set forth in Rev. Rul. 68-360, 1968-2 C.B. 197 in accordance with IRC section 461, in which the IRS **acquiesced** with the Tax Court in **Best Lock Corporation v. Commissioner**, 31 T.C. 1217 (1957). As stated in Rev. Rul. 68-360, the Court ruled "the costs of producing a catalog having a useful life of more than one year are capital items and not ordinary and necessary business expenses. Trade catalogs are no different from other assets used in a taxpayer's trade or business. Where the useful life of such assets exceeds one year, their costs should be capitalized and depreciated over such useful life. Accordingly, costs incurred in the publication of the taxpayer's trade

catalog are not deductible as ordinary and necessary business expenses but must be capitalized and depreciated over the useful life of the catalog.

## **AUTO**

A manufacturer may own several vehicles ranging from luxury autos to vans to trucks. For those vehicles used to deliver goods or to pick up supplies, there is usually no problem with the expenses incurred to run and operate them. The primary issues usually involve automobiles used by shareholders, officers, or employees for personal use.

Issues involving auto expenses may take many directions. Be aware that issues may involve a question of deductibility by the corporation, as well as income issues to the shareholder, officer, or employee as well as employment taxes.

Issue development will depend upon the situation. Ascertain whether the corporation owns the vehicles and allows use by a shareholder, officer, or employee or whether the corporation reimburses the individual for use of his or her vehicle. Entirely different issues may arise when the corporation leases vehicles and again allows the above stated individual personal use of the vehicle.

### **Vehicle Owned by Corporation**

Deductibility of the auto expenses incurred for a corporate vehicle depends upon who is using the vehicle. Different rules provided by Treas. Reg. section 1.162-25T and IRC section 280F are governed by whether the user is an employee, an officer, or a shareholder. Deductibility is also governed by whether the vehicle meets the 50 percent "Qualified Business Use" test.

1. Use by unrelated nonshareholder employee. Per Treas. Reg. section 1.162-25T, if an employer includes the value of a noncash fringe benefit in an employee's gross income, the employer may not deduct this amount as compensation for services, but rather may deduct only the costs incurred by the employer in providing the benefit to the employee. Various regulations have been published establishing methods to compute the fringe benefit portion. (See Treas. Reg. section 1.61-21 for fringe benefits provided after 1988.)

If this is the case, or if a like amount is reimbursed by the employer, operating expenses are wholly deductible and depreciation is allowable up to 100 percent of the maximum amount subject to IRC section 280F. If the value is not included in the employee's gross income however, the personal portion of its use is not considered to be qualified business use and, therefore, the depreciation and operating expenses incurred for nonqualified business use are not deductible.

2. Use by a 5-percent owner or a related person. If the vehicle is used by a 5-percent shareholder or a related person as described in IRC section 267(b), the above income inclusion exception does not apply and the personal use portion is never considered to be qualified business use. Therefore, even if the 5-percent shareholder includes a certain portion of compensation in his or her income for personal use of a company automobile, the personal use portion will never be considered "qualified business use" and the depreciation and operating expenses must be appropriately adjusted. It is not uncommon to increase shareholder compensation or adjust his or her loan account based on personal auto use and also to deduct the full allowance for depreciation available for the period. More often, however, no additional compensation is computed and a constructive dividend should be assessed, equal to the fair market value of personal vehicle use, as well as an adjustment to the expense accounts.
3. In the case of a Form 1040 examination. The vehicles used in the Schedule C business are treated in the same way a corporation treats nonbusiness use by a 5 percent shareholder or related person.

### **Vehicle Owned by Shareholder**

Monthly principal and interest payments for one or more vehicles owned by the shareholder (or sole proprietor) are often made by the company and deducted as auto expense. In the case of a corporation, the payments made on the shareholder's behalf constitute a constructive dividend, with the interest element subject to consumer interest deduction restrictions on the Form 1040.

Other auto expenses paid by the corporation, such as the cost of fuel, maintenance, accessories, insurance, and registration, are also made for the benefit of the shareholder and are subject to partial or full disallowance depending on the extent of reimbursable business use. It is not unusual to find that insurance policies cover all of the shareholder's family cars or the company credit card is routinely used to supply fuel for a number of nonbusiness vehicles.

### **Vehicle Owned by Nonshareholder Employee**

Business use of the employee's personally owned vehicle is generally reimbursed in one of three ways. The employee will receive a flat monthly auto allowance payment, submit a travel voucher, and receive reimbursement for specific miles driven based on a standard mileage rate or for actual expenses incurred and detailed on the expense report.

In the case of specific reimbursement or the standard mileage rate, you will have no audit issue as the employee is not required to report this as income and the employer

may deduct the amount in full as auto expenses.

In the case of a flat monthly auto allowance, ascertain whether the amounts are included in the employee's Form W-2. If the amounts are included in the Form W-2, there is no audit issue. If, however, the amount is not included in the Form W-2, the employee has additional compensation that must be picked up on the Form 1040 and adjustments made to the employment tax returns. In this case, the employee is eligible for a deduction for employee business expenses.

### **Leased Vehicles**

Personal use of vehicles leased by the corporation is taxable to the user based on the percentage of personal use multiplied by the fair lease value of the vehicle. If the lessee is a corporation and has not made this addition to a shareholder's compensation or has not been separately reimbursed by the shareholder, the excluded amount constitutes a dividend paid to him or her.

Businesses leasing luxury autos are required to include in income an "inclusion amount" as computed in the Treas. Reg. section 1.280F-5T. This adjustment is often overlooked or miscalculated by the taxpayer. See Chapter 5 for further reference.

### **BAD DEBTS**

The deduction of a bad debt expense is governed by IRC section 166. A deduction for a bad debt may only be taken in the year the debt is determined to be worthless.

### **Determination of Worthlessness**

In general, the best evidence of the worthlessness of a bad debt is if the customer filed bankruptcy and the debt was discharged in full or in part. In lieu of bankruptcy, the next best evidence would be for the taxpayer to have filed suit against the customer, received a judgment for payment, and subsequent collection attempts were unsuccessful.

The Treasury Regulations specifically state, however, the taxpayer is not required to take legal action for an amount to be deemed worthless. Legal action is not required "if the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment." (Treas. Reg. section 1.166-2(b))

Therefore, the taxpayer is only required to provide documentation to the examiner's satisfaction that the amount in question is worthless. Examples of documentation would include in-house collection attempts, referrals to outside collection agencies,

and written agreements with the customer for reduction in the overall amount owed.

### **Amount of Deduction**

Prior to the passing of the Tax Reform Act of 1986, taxpayers were allowed to deduct either the adjusted basis of the bad debt or a reasonable addition to a reserve for bad debt account. For tax years beginning after December 31, 1986, however, the deduction may only be taken for a specific item which has been determined to be worthless.

Assuming the taxpayers use the allowance for bad debts method allowed for in financial accounting, in corporate examinations one should review the Schedule M-1 for an adjustment for an allowance for bad debts. For financial accounting purposes, the taxpayer will deduct the current year's addition to the allowance account. However, for tax purposes, as stated above, this is no longer allowable. Therefore, there should be an adjustment between the books and the tax return for this item.

### **Examination Techniques**

In corporate examinations, the first step you take should be the review of the Schedule M-1 adjustments. As discussed above, there should be an adjustment to account for the differences between financial and tax accounting.

In all examinations, the initial interview should contain questions regarding the taxpayer's policy regarding the write-off of a bad debt. The specifics as to how the taxpayer determines when an amount is uncollectible will direct you as to how to proceed in the examination of this item. In addition, one should also ask about the taxpayer's policy for recognizing subsequent recoveries.

If the tax return has a deduction for bad debts or you have identified bad debts as an issue through examination of accounts receivables, the following steps should be taken by you as a minimum in the examination of this account:

1. **Bad Debts Schedule.** Request a detailed schedule for the bad debt deduction. This schedule will show the debtor and amount of the debt.
2. **Accounts Receivables Aging.** Trace the detailed schedule to accounts receivables aging schedules prepared periodically during the year. (If taxpayer has them.) This step will allow you to test the information received during the initial interview. For example, if the taxpayer states that accounts are written-off once they are in excess of 120 days overdue, the amounts shown on the detail schedule should only be found in the aging schedule in the over 120 day column.

3. Vendor File. Request the vendor files for the specific write-offs.
  - a. Review the original sales invoice. For sales which were made in the current year, trace to the sales journal to insure the amount was actually reported in income.
  - b. Review correspondence and notations by the credit manager/collections person for collection attempts. If there were no collection attempts, how did the taxpayer determine the amount was worthless? (See the discussion on worthlessness above.)
  - c. Review the file for evidence of subsequent collections. If the taxpayer recovers a good percentage of bad debts previously written-off, determine whether the write-off policy is reasonable.

### **CAPITAL EXPENDITURES VERSUS CURRENTLY DEDUCTIBLE ITEMS**

During the examination of various line items on the tax return, always consider whether the amounts claimed are currently deductible under IRC section 162 or should be capitalized under IRC section 263.

The most common account in which YOU will encounter items which should have been capitalized rather than expensed is the repairs and maintenance account. However, capitalizable items can be found within any line item on the return or any account in the books.

A capital item is defined in Treas. Reg. section 1.263(a)-1(a)(1) as "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property." Treas. Reg. section 1.263(a)-1(a)(2) further provides that a capital expenditure is "any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion."

This definition is further explained in Treas. Reg. section 1.263(a)-1(b) as "amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use."

In contrast, repairs and maintenance expenses are described in Treas. Reg. section 1.162-4 as "incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition."

## Examination Techniques

1. Initial Interview. During the initial interview, ask the taxpayer to explain company policy as to the level of expenditure considered to be a capital item. Generally, the company will have a standard policy regarding capital versus expense items. For example, the taxpayer states that they capitalize all items over \$2,000. You would then look for expenses greater than \$2,000 to determine the taxpayer's consistency in following their own policy. If it is determined the taxpayer is inconsistent, the scope of the audit may need to be expanded.
2. Review Cash Disbursements Journal. In addition, a very simple examination technique used in smaller examinations (activity code 211 to 215 for corporations) to determine whether the taxpayer has deducted potential capitalizable items is to review the cash disbursements journal. Be looking for expenditures which appear to be excessively large relative to other expenditures and make note of the account to which these large items are posted.

Then look to the posting account and locate the vendor for the expenditure in question. At this point, one is looking into a specific account and should review for regular vendors in that account to see if the payee of the large expenditure is a regular vendor for the account. If the payee is a regular vendor, the amount would generally not require any further action.

If the payee is not a regular vendor, then request the invoice to determine the exact nature of the expenditure. At this point, the determination can be made as to whether the item is capital or has been properly expensed.

3. Review repairs and maintenance accounts. In larger examinations (activity code 217 and above), step #2 above would generally not be warranted unless you have determined the taxpayer has poor internal controls. If the internal controls are good, you would generally go directly to the repair and maintenance accounts to check for excessively large expenditures. In this case, you would generally request invoices for all excessively large expenditures to insure they are properly expensed.
4. Review year end adjusting journal entries. Rather than deducting the amounts during the year, the taxpayer may make an adjusting journal entry at year end to expense the amounts previously capitalized during the year. As this is an extremely easy adjustment to spot, most sophisticated taxpayers would not do this, however, keep this in mind.

While examining the office expense account, a team member noticed the taxpayer had purchased computer software and expensed the amount through a journal

entry at year end. The computer software cost in excess of \$3,000. If the company had taken a IRC section 179 deduction in the year placed into service, there would have been no issue. However, in order to deduct a IRC section 179 expense deduction, the taxpayer must elect to do so in the year placed in service.

5. Expense Account Examinations. Be alert for capital items during the examination of any expense on the return. For example: While examining the computer supplies account, a team member noticed the taxpayer had purchased a computer system and associated software. In addition, while examining the purchases account, he noticed the taxpayer deducted the cost of a computer system. This same issue was noticed during the examination of auto expenses with respect to the costs of rebuilding a truck engine and transmission.

In both cases, the team member disallowed the expense, capitalized the item, and allowed depreciation expense. As the taxpayer had failed to elect IRC section 179 on the original return, the taxpayer was not allowed to reclassify the items in order to keep the full deduction.

### **Pollution Control Permits**

In Southern California, the Air Quality Management District (AQMD) issues permits which regulate the quantity of allowable emissions each day. These permits are tightly controlled and a manufacturer must obtain additional permits by purchasing permits from other manufacturers which are either moving or going out of business. These permits regulate the quantity of emissions rather than the type of emissions. In addition, during 1987, the AQMD began to change its spraying regulations from oil based solvents to water based solvents by 1994.

In one case, a team member noticed a manufacturer had purchased additional pollution control permits for approximately \$300,000. The taxpayer originally began to amortize the permits over a 40 year life. With the change in the AQMD regulations in 1987, the taxpayer decided the useful life of the permits should be reduced to 7 years.

IRC section 167 states in order for an intangible asset to be depreciable, it must have a determinable useful life. These permits will remain in effect so long as the taxpayer pays the yearly fees and stays in the business of producing furniture. The deductibility of the yearly fees is not in question and is allowable as a normal business expense. However, the question in this case is whether these permits have a determinable useful life. Based on research in this area, it is the team member's opinion the permits would not have a determinable useful life and would, therefore, not be subject to amortization.

## **COMMISSIONS**

During the initial review of the tax return, note whether the taxpayer is deducting commissions expense. If so, the following questions should be asked during the initial interview.

1. What is the range of commission percentages?
2. At what point is a sale considered valid for purposes of computing the commission (when invoiced, when shipped, when customer makes payment)?
3. If goods are returned by the customer or a credit memo issued, when is the salesperson's commission "reversed" (that is, when does the commission become "unearned")?
4. Are the salespersons employees or independent contractors? If so, are they truly independent? See Chapter 3 of this guide for further information on employee versus independent contractor status.

The furniture manufacturers examined generally paid commissions to both in-house (employees) and outside salespersons. The commissions are based on a percentage of the sales generated. For example, in one case, a team member noted the salespersons were paid 8 percent of the dealers price. The dealer's price, as defined by that company, was the wholesale price and was equal to 45 percent of the manufacturers list price. In a separate case, the in-house sales force computed an estimated "cost" for a sale and was paid a percentage of the estimated net income from the sale. Once the actual cost was subsequently determined, the salesperson's commissions were adjusted to reflect the actual net income from the sale. Finally, in another case, the shareholder paid himself a 30 percent sales commission. As the normal commission percentage was 8 percent, the additional 22 percent commission paid was actually a disguised dividend.

Often, the taxpayer will have a full-time salesperson located at their showroom. This salesperson will generally be an employee, therefore, the examiner should ascertain whether the taxpayer is properly treating such individual as an employee.

## **DEPRECIATION**

Depreciation expense is allowed as a deduction using the provisions of IRC sections 167 and 168. In addition, IRC section 179 allows a taxpayer to expense a certain amount in the first year the property is placed in service. The discussion below is not meant to be a comprehensive discussion of the provisions of depreciation. Rather, it is

a discussion of the areas encountered by the team members in the examination of furniture manufacturing returns.

**Revenue Procedure 87-56**

Rev. Proc. 87-56, 1987-2 C.B. 675, sets out the class lives of property to be used in the computation of depreciation expense. Asset class 24.4 gives the class life of 10 years which translates into a recovery period of 7 years under the general depreciation system for "assets used in the production of plywood, hardboard, flooring, veneers, furniture, and other wood products, including the treatment of poles and timber." If the taxpayer elects to use the alternative depreciation system allowed in IRC section 168(g), the life is 10 years under IRC section 168(g)(2)(c)(i). Several of the taxpayers examined in this study utilized a recovery period of 5 years and the appropriate adjustments were made. See Chapter 4, of this guide for further information.

**Listed Property**

Limitation Relating to Listed Property. IRC section 280F(a) limits the amount of depreciation allowable on luxury automobiles and other listed property.

Listed property is defined in IRC section 280F(d)(4) and includes automobiles, computers, and generally property a taxpayer uses for both personal and business purposes. See Treas. Reg. section 1.280F-6T(b) for a detailed explanation of the types of property included as listed property.

For luxury automobiles, IRC section 280F(d)(7) uses an automobile price inflation adjustment for vehicles placed into service after 1988. The cost recovery limitations have been revised through revenue procedures as follows:

Revenue Procedure	Calendar Year Vehicle Placed in Service	Tax Years			
		1st	2nd	3rd	Subsequent
89-64	1989	\$2,660	\$4,200	\$2,550	\$1,475
90-22	1990	2,660	4,200	2,550	1,475
91-30	1991	2,660	4,300	2,550	1,575
92-43	1992	2,760	4,400	2,650	1,575
93-35	1993	2,860	4,600	2,750	1,675

For years subsequent to 1993, you are advised to research the appropriate dollar limitations.

In addition to the above limitations, IRC section 280F(d)(1) limits the deduction allowable under IRC section 179 to the amount described above for the first year the property is placed in service. For example, a taxpayer places a luxury automobile which costs \$30,000 into service in 1991 at 100 percent business use. If the taxpayer elects to apply IRC section 179, the deduction is limited to \$2,660 even though the IRC section 179 maximum expense may be \$10,000. The obvious question then becomes, why would a taxpayer elect to include a luxury automobile in his IRC section 179 expense for the year? If the taxpayer properly computed the IRC section 179 expense, obviously the answer would be to not include the luxury automobile. However, if the expense is improperly computed, the taxpayer may include \$10,000 for the automobile. Therefore, carefully scrutinize the assets included in an IRC section 179 deduction for any tax year. As the election to include assets as a deduction under IRC section 179 must be made in the year the property is placed into service, the taxpayer would not be allowed to substitute other property into the IRC section 179 deduction.

For all listed property, if the property is used less than 50 percent for business, the deduction for depreciation must be computed under IRC section 168(g). This provides for straight line depreciation over a specified class life utilizing the appropriate convention based on when the property is placed in service during the year. In addition, the property is not eligible for the expense election under IRC section 179 (Treas. Reg. section 1.280F-3T(c)(1)).

Once the appropriate dollar amount of the depreciation has been determined, the taxpayer must then adjust that amount for nonbusiness use. For example, an automobile placed in service in 1991 and used 100 percent for business is allowed a maximum depreciation deduction of \$2,660 in the first year. However, if the business percentage is only 55 percent, the taxpayer is only allowed 55 percent of the maximum depreciation deduction they would have been allowed under the applicable Revenue Procedures listed previously. Therefore, in this case the deduction would be 1,463 (55 percent times \$2,660) for the first year.

**Reduction in Business Use:** If a taxpayer places any of the above property in service at a greater than 50 percent business use and subsequently the business use percentage falls below 50 percent, IRC section 280F(b)(2) becomes applicable.

Under the provisions of this section, in the year the business use falls below 50 percent, the taxpayer must recapture (restore) to income the excess of (1) the depreciation deductions previously taken over (2) the depreciation that would have been allowable if the straight line depreciation had been used under IRC section 168(g).

## **Examination Techniques**

1. Reconcile the books to the return. Generally, a reconciliation between depreciation expense per the books and the return will result in a difference. This is due to the fact that depreciation per the tax return will be computed differently.
2. Comparative Review. Review the depreciation schedules for two or more years. If the schedules are not attached to the tax returns, request them from the taxpayer.

Items of equipment that appear on the schedule for one year and not on the next may have been sold. Check to see that any income from the sale of assets is properly reported. Question the taxpayer as to the disposition. The item may have been abandoned or merely fully depreciated and removed from the schedule in lieu of having been sold.

3. Review Depreciation Rates. Check to see the appropriate MACRS (or other) rates are applied correctly for furniture production (7 years) versus items like furniture and fixtures (5 years).

Also, check to see if the same pieces of equipment are consistently treated in the same fashion. In one case, the depreciation rate changed from 7 years to 5 years. In the same case, the basis of the equipment changed also. In general, since most tax return depreciation schedules are now computer generated, if the computer input is incorrect, the depreciation expense will be incorrect.

4. Review Assets Included in IRC Section 179 Expense. If a IRC section 179 deduction was taken, be sure to check whether the basis of the asset has been appropriately reduced prior to the computation of depreciation.

## **DUES AND SUBSCRIPTIONS**

As in all cases, in order to deduct dues and subscriptions, the taxpayer must show the amounts claimed are for publications and organizations directly related to their business.

During the examinations of furniture manufacturers, deductible payments were made to the following trade associations: Local 721 Cabinet Makers & Millmen; Southern California Association of Cabinet Makers; California Furniture Manufacturers Association (CFMA) aka Association of Western Furniture Supplies (AWFS); West Coast Furniture Fabric Club (WCFFC); Young Furniture Association (YFA); and

Business & Institutional Furniture Manufacturing Association (BIFMA).

In addition, the manufacturers subscribed to the following publications: Furniture Design and Manufacturing; Manufacturing & Engineering; Modern Woodworking; Barrett's; Furniture Today; Kitchen Bath & Design; Wood & Wood Products; Design Solutions; Designer's West; Architectural Digest; and Wood Design.

As shown, the furniture manufacturing industry has a wide variety of associations and publications. You may encounter the above, in addition to others not listed.

## **INSURANCE**

Insurance premiums are a major cost of doing business in California for all businesses, especially for furniture manufacturers. In Southern California, workman's compensation insurance is a particularly significant expense.

In general, you will see deductions for health, auto, workman's compensation, and property insurance. In addition, deductions for life insurance premiums were seen in many cases. Life insurance premiums are limited in deductibility and are discussed further.

The examination of insurance expense is especially important in small, closely-held corporations. One team member discovered the personal insurance expenses of the shareholders was being deducted in the various insurance expense categories on the return. In this situation, the deduction was disallowed and the shareholder was required to recognize constructive dividend income.

### **Life Insurance**

The deductibility of premiums paid on life insurance policies is governed by IRC section 264.

In corporate examinations, the first step is done during the initial review of the return. Review the Schedule M-1 for an adjustment for nondeductible premiums paid for life insurance covering corporate officers, employees, or any person who has a financial interest.

In all examinations, the initial interview should include a question regarding the existence of life insurance policies and who pays the premiums on any policies. Regardless of the answer to this question, the examination should include testing to see if the taxpayer deducted life insurance premiums because there are several types of issues you may encounter.

Group-term life insurance is governed by IRC section 79. If an employer provides group-term life insurance for its employees, the employee may have taxable income if the insurance benefit provided to the employee exceeds \$50,000. Total premiums which exceed this amount will be taxed to the employee based on the table provided in Treas. Reg. section 1.79-3. For further detail, see IRC section 79 and the associated Treas. Reg. sections 1.79-0 through 1.79-4T.

Split-dollar life policies should be reviewed to determine if suggested assignments and endorsements have been made as to ownership and beneficiary, and if the employee has been taxed on, or paid the company the value of the economic death benefit. The premium will be paid by both the employer and employee, however, the employer cannot deduct its share of the premium. The amount of the benefit can easily be approximated using a table of PS-58 costs which can be found by looking in the RIA or CCH tax handbook.

The final issue to be discussed with respect to life insurance premiums relates to policies covering company officers, employees, and financially interested parties where the corporation is the beneficiary. This issue was encountered numerous times by team members in the examinations of furniture manufacturing returns.

If the company is directly or indirectly the beneficiary of any such policy, no deduction is allowable. In the case of a corporate examination, the amount paid should be shown as a Schedule M-1 adjustment. If the corporate shareholder is the owner and beneficiary of the policy, his or her compensation should be increased to reflect the benefit or his or her loan account adjusted. If this is not the case, the premium paid constitutes a nondeductible dividend paid to the shareholder. In the case of an employee unrelated to a shareholder, the premiums paid constitute additional compensation to the employee. As for a sole proprietor, no deduction is allowable.

In all examinations, the amount of the premiums paid and deducted should be verified. In one corporate examination, a Schedule M-1 adjustment was made for officer's life insurance premiums. However, the actual premium paid was greater than the M-1 adjustment and an examination adjustment was thus made.

### **Other Issues**

Another potential expense/dividend issue involves payment of health insurance premiums or medical expenses on behalf of shareholders. The issue is whether the payments are being made on behalf of the owners as employees or shareholders. If a health insurance policy is available, request the policy to determine who is covered. The deductibility of the expense will depend upon whether the policy is a nondiscriminatory plan and covers all eligible employees in a similar fashion. In some cases, adjustments were made to the corporation as well as shareholders because

insurance premiums were paid on a discriminatory plan.

Did the taxpayer receive insurance rebates during the year? During the initial interview, ask if the taxpayer has been audited for workman's compensation insurance purposes. The results of a workman's compensation audit may be a rebate which should be included in income. Request the file for the workman's compensation insurance and review for evidence of an audit. While auditing cash, keep in mind the potential for deposits from insurance rebates that may not have been booked into income.

## **LEGAL AND PROFESSIONAL**

In the examination of legal and professional expenses, always be aware of the possibility of shareholder personal expenses being paid by the corporation or contingent liabilities due to potential lawsuits.

### **Examination Techniques**

1. Analyze material year end journal entries. If at year end the taxpayer makes an accrual for legal and professional expenses, the items should be carefully scrutinized. For example: While inspecting the invoices, the examiner notes the taxpayer is in the middle of a lawsuit. Although the suit is not yet settled, the taxpayer has a liability account on the balance sheet for the potential liability. In addition, the taxpayer has deducted amounts for losses due to the lawsuit on the income tax return. After further questioning of the taxpayer, the examiner discovers that the amount deducted is based on an estimated loss amount. As the amount does not meet the all events and economic tests per IRC section 461(h), the examiner properly disallows the deduction.
2. Review payments and invoices for unusual time periods. If a CPA prepared audited financial statements or the tax return, it would not be unusual for large accounting or tax preparation fees to be incurred just prior to and just after the fiscal year end. However, payments made to the CPA after the individual tax filing season (April/May) or the extension season (Aug/October) should be scrutinized closely. It may be the corporation is paying for the preparation of the shareholder's tax return.

#### **Example 1**

During the initial interview, a corporate shareholder stated that he had prepared the corporate tax return. During the examination of this account, the examiner noted payments to a CPA firm. Examination of the specific invoices revealed the payments were in fact for the preparation of the shareholders personal return. Thus, the deduction was disallowed and constructive dividend income assessed against the shareholder. In

addition, the examination was expanded to the subsequent year for the same adjustments.

Additionally, legal expenses should be thoroughly examined if you know, or suspect, the shareholder has gone through a divorce during the year under examination. It is not uncommon for the corporation to pay the court costs incurred for a primary shareholder. Again, this is a personal expense of the shareholder and not deductible under IRC section 162.

## **PENSION PLANS**

Many of the companies examined maintained a pension plan for its officers and nonunion employees.

### **Examination Techniques**

1. Referral Checksheet. During the initial review of the tax return, look to see if a deduction is taken for a pension plan. If yes, you will need to complete Form 4632-A.

The Form 4632-A is the Employee Plans Referral Checksheet. This form asks various questions in a yes or no format. In completing the form, you will be directed as to whether a referral needs to be made to the EP/EO Division. This form should be completed as early in the examination as possible. If a referral is required, the EP/EO Division can be evaluating the referral while the remainder of the income tax examination is proceeding. Note: If a referral is made, the case cannot be closed until EP/EO has completed its work because of possible income tax adjustments. Generally, if the referral will not be worked, you will receive a rejection notification within 4 weeks. If after 4 weeks, you have not heard from EP/EO, contact the classifications person for a status check on the referral.

If a referral is required, you are directed to IRM 45(10)1.3 for details on the referral procedures.

2. Form 4632-A. Question 10 on the 4632-A addresses the timing of the payment to the pension plan. If the payment was not made within the time period referenced, the deduction is not allowable for the year under examination.

## **RENT**

The examination of rent expense is an item that should not be overlooked. Property rental for furniture manufacturers may include both real and personal property. Real

property may include the company headquarters, manufacturing operations, showrooms, furniture marts and space at trade shows. Personal property may include equipment, computers, and automobiles.

The initial interview should contain questions regarding the types of property leased by the taxpayer. In addition, questions should be asked regarding the leasing of property from any related parties. The issues involved in rent expense generally dealt with rentals between related parties. In many of the corporate examinations conducted, the companies have been in business for many years and the shareholders owned the business property. In this situation, the shareholders often paid themselves higher lease amounts in lieu of salary subject to employment taxes.

## **Examination Techniques**

### **Real Property**

1. **Review Lease Agreements.** Review the lease agreements for the types of property being leased. This review will give the lease terms, deposit requirements, any lease acquisition fees, rental base and charges, including provisions for cost of living increases. Once the rental agreements have been reviewed, the total deductible rent for the year may be easily computed using the amounts provided for in the lease agreements.

If you computes a rental cost substantially less than that deducted on the return, this may lead to additional rental property for which you were not provided a copy of the lease agreement. Possibilities for holding back lease agreements include rental arrangements between related parties which do not reflect true fair rental values or payments made by the corporate or partnership entity on behalf of a shareholder or partner.

2. **Trace Rental Deposits.** Trace the rental deposits per the lease agreements to the balance sheet. A team member encountered the situation where a deposit was not on the balance sheet and had been deducted as rent expense.

Deposits are not amortizable and are not deductible by the taxpayer unless the amount has been used at lease termination or is otherwise released for use by the lessor.

3. **Lease Acquisition Fees.** Some leases include provisions for an acquisition fee. If this is the case, the fee may be amortized over the term of the lease rather than deducted in full when paid/accrued. See Treas. Reg. section 1.162-11(a).
4. **Analyze Lease Agreements.** When analyzing the lease agreements, take into

account the reasonableness of the charges. You need to be watchful for rentals between related parties and should give close attention to the amounts charged to determine whether a fair rental value is being paid. In general, it is assumed that if the taxpayer is leasing property from an unrelated third party the rental charges are at fair rental value. If, however, the amount charged seems unreasonable to you, leases charged by apparent third parties should also be carefully scrutinized. Possibilities include lease arrangements between a corporation and a shareholder's family member with a different surname.

One research tool that can be used to determine whether the taxpayer is paying a fair rental value is the Black's Office Leasing Guide, available at the Los Angeles City Library. This guide breaks the Los Angeles area into sections and gives information based on square feet of space leased and the types of leases available on various buildings around Los Angeles County.

You may also check with real estate brokers in the area of the property. The real estate offices will be able to give you an idea of the fair rental values in the area.

If further examination work is warranted and the dollar amount significant, you should, with your manager's approval, make a referral to the Engineering Division to determine if there is an issue. If this step is warranted, it is suggested the referral be made as early as possible in order to give the Engineering Division time to complete its work while the remainder of the exam is in process. The engineering referral is made on Form 5202 and the procedures are outlined in IRM 42(16)2.

5. **Timing of Deduction.** In addition to the question of fair rental value, there is another issue to be considered when there is a rental of property between related parties as defined in IRC section 267(b). IRC section 267(a)(2) provides that a deduction is allowable to an accrual basis taxpayer in the year in which the income is includible by the related party.

#### **Example 2**

A corporation whose year end is December 31, 1991, pays its shareholders \$200,000 during the year for rent. In addition, it also accrues another \$200,000 of rent expense to the same shareholder at year end. The 100 percent shareholder has filed his 1991 Form 1040 return and has reported \$100,000 on his Schedule E. At this time, the examiner has two separate issues:

1. The corporation is only allowed to deduct the amount of rent which is includible in the shareholder's income at the time of the transaction. In this case, since the cash payment of \$200,000 was made to the cash basis shareholder and was required to be included in his income, the \$200,000 accrual at year end is disallowed for corporate year 9112.

2. The examiner has a \$100,000 unreported income issue on the shareholder's return. The corporation still gets the full \$200,000 deduction since that was the actual payment made to the shareholder.

### **Personal Property**

1. General. In general, the items discussed above regarding real property also apply to personal property.
2. Fair Rental Value. An interesting issue was encountered and developed by an agent which warrants mention in this section.

The issue involved the leasing of a special piece of furniture equipment from a shareholder to his related corporation. The parties had executed an equipment lease with general terms of \$12,000 per month for 50 months. The equipment had a value around \$395,000 with no liabilities attached to it. The shareholder was to make a profit well in excess of \$205,000. During the term of the lease, the corporation never paid the shareholder a salary as he relied strictly on the rental income.

The agent questioned this arrangement in terms of whether it was truly an arms length transaction. A referral was made to the Engineering Division but was rejected due to the small dollar amount involved. Due to complications involving the history of the equipment, any attempts to find the fair rental value for a similar piece of equipment through companies leasing such equipment would have been very difficult.

The agent, with advice from the engineer, determined the fair rental value on the equipment based on three primary factors: Return on capital, risk free rate of leasing, and risk of investing. Other factors involved tax savings on the depreciation of the equipment and salvage value. Using information such as original value of the equipment, the Applicable Federal Rate of interest, the lease terms, and present value tables, the examiner managed to compute a fair rental value himself. The formula involves computing a lease payment in much the same fashion that a monthly house or auto payment would be computed using the above mentioned factors.

This guide cannot provide a step by step formula for computing the fair rental value as there were many complications involved in the above situation. However, it should be pointed out that if you are faced with similar situations, you should consult with the Engineering Division for possible assistance in performing a computation themselves.

3. Rental Payments for Personal Use. If lease liabilities are not included on the balance sheet, examination of the disbursements may reveal payments for equipment leased for the benefit of the shareholders.

### **STATE INCOME TAX**

The deduction for state income taxes is governed by IRC section 164. For accrual basis taxpayers, the timing of the deduction depends on the state to which the income, franchise, and similar taxes of particular states was paid.

You will find revenue rulings have been issued for various states, however, only the deduction for California will be discussed. Examiners encountering amounts paid for taxes to other states should research the rules for the particular state involved. The deduction for California state franchise tax is governed by Rev. Rul. 79-410, 1979-2 C.B. 213.

In all corporate examinations, the initial review of the return should include the Schedule M-1 adjustments. Absence of an adjustment for state income tax may indicate an issue.

Under present California law, the tax for the first year a corporation commences business after 1971 is a minimum tax prepaid upon incorporation. The second year's (tax year) tax is measured by the first year's income and prepaid during the first year (income year). The franchise tax continues to be prepaid in this manner until dissolution.

For federal tax purposes, the franchise tax is deductible in the tax (second) year, not in the income (first) year. For financial accounting purposes, it is deducted in the income year, or the year in which it is prepaid. Thus, the federal tax deduction on a 9112 corporate return should represent the franchise tax prepaid and deducted on the books in 9012. The 9112 prepayments cannot be deducted until 9212. This timing difference requires an M-1 adjustment, which can be significant when there are differing tax rates or income fluctuations.

### **TAXES AND LICENSES EXPENSE**

The deductibility of taxes and licenses expense (referred to as taxes below) is governed by IRC section 162. IRC section 162(f) specifically denies a deduction for any amounts paid as a result of a violation of any law. Therefore, fines and penalties are nondeductible business expenses.

The furniture manufacturers examined were subject to reporting requirements and

regulations by various state and federal agencies. Be watchful for payments to the following agencies: Air Quality Management District (AQMD), Bureau of Home Furnishings, State of California, Water Conservation Board, Occupational Safety and Health Administration (OSHA), Environmental Protection Agency (EPA), State Water Resources Board, California Redevelopment Agency, and the Immigration and Naturalization Service (INS). Payments to any of these and other governmental agencies should be questioned as to the nature of the payment.

### **Examination Techniques**

1. Review Schedule M-1. In corporate examinations, review the Schedule M-1 adjustments for nondeductible fines and penalties.
2. Review Cash Disbursements. In all noncorporate examinations, and in the case of no adjustment on the corporate Schedule M-1, scan the cash disbursements journal for payments to the agencies listed above in addition to the fire department and other government agencies or municipalities. During many of the examinations, it was noted that the taxpayers were deducting amounts paid for penalties and fines.
3. Contact AQMD. In addition to the above steps, you can contact the AQMD directly to determine whether the particular taxpayer has been assessed fines. See Exhibit 9-1 at the end of this chapter for a sample of this third party contact letter.

### **TRAVEL AND ENTERTAINMENT**

The deductibility requirements for travel and entertainment expenses is the same in furniture manufacturing as in other industries. In general, you will see expenses related to trade shows and furniture marts, in addition to the normal entertainment of clients, prospective clients, and suppliers.

Travel for trade shows and furniture marts can include such destinations as High Point, NC, Chicago, Dallas, and San Francisco. Local furniture marts include the Pacific Design Center in Hollywood and the Los Angeles Mart.

### **Deduction Limitation**

For tax years beginning after December 31, 1986, the deduction for meals and entertainment expense is, with limited exception, limited to 80 percent of the total amount spent during the year (IRC section 274(n)). The exceptions to this rule may be found in IRC section 274(n)(2) as cross referenced to IRC section 274(e). Note: For tax years beginning after December 31, 1993, this limitation has been revised to 50 percent. For partnerships and S-Corporations, the percentage limitations are based

on the shareholder's or partner's tax year. The examiner should research this item when encountered.

In the case of a corporate examination, a review of the Schedule M-1 should reveal an adjustment for the nondeductible portion of the meals and entertainment expense. In noncorporate audits, a difference between total amount spent and the deduction per the return should be noted during a reconciliation between the books and the tax return.

### **Recordkeeping Requirements**

The deduction for travel and entertainment expenses is subject to strict recordkeeping requirements as found in IRC section 274(d). The taxpayer must maintain contemporaneous records to show the amount, time, place, business purpose, and business relationship.

In the case of employee salespersons, the company will generally require the filing of expense reports. Reimbursement to the employee will be made based on these expense reports and will generally contain the information required by IRC section 274(d).

### **Revenue Reconciliation Act of 1993**

The Revenue Reconciliation Act of 1993 made three important changes to the deductibility of travel and entertainment related expenses.

1. **Deduction Limitation:** As mentioned previously, the deductible amount of meals and entertainment expenses was reduced from 80 percent to 50 percent for tax years beginning after December 31, 1993. This may encourage taxpayers to classify these types of expenses in accounts other than those titled "Travel and Entertainment."
2. **Club Dues:** Prior to passage of this Act, a deduction was permitted for club dues in certain circumstances even though a significant element of personal enjoyment may have existed. The Act specifically bars all deductions for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose. This is provided for in IRC section 274(a)(3) which was added to IRC section 274 for amounts paid or incurred after December 31, 1993.

3. Taxpayer's Spouse or Dependents: The deductibility of amounts related to travel for a taxpayer's spouse or dependents were tightened for amounts paid or incurred after December 31, 1993. The Act specifies the following requirements in order for the amounts to be deductible:
  - a. The spouse or dependent must be an employee of the taxpayer
  - b. The spouse or dependent must have a bona fide business purpose for traveling
  - c. The expenses must be deductible by the spouse or dependent as an employee business expense if the company had not reimbursed them for the travel.

### **Examination Techniques**

1. Initial Interview. During the initial interview, ascertain the company's policies with respect to record keeping and reimbursement of travel and entertainment expenses. It is important to ask whether the principals of the company are subject to the same requirements as other employees. If they are not, ask questions as to the differences and verify through the records that expenses related to the principals of the company are properly documented.
2. Shareholder Expenses. The travel and entertainment expenses related to the shareholder should be particularly scrutinized, since, if the company has a practice of paying personal expenses of the shareholder, the shareholder should be recognizing income in the form of dividends or a loan account should be debited. If this has not been done, the personal expenses would be a constructive dividend to the shareholder per IRC section 301.

Note: Although the corporation may have only deducted 80 percent (or 50 percent after December 31, 1993) of the meals and entertainment expenses (which would be disallowed due to the examination), the shareholder will have income of 100 percent of the amount paid. This is because the corporation is deemed to have paid 100 percent of the amount to the shareholder and the shareholder is deemed to have actually paid the expense.

3. Other Accounts. Throughout the examination, you need to be watchful for travel and entertainment expenses which have been included in accounts other than "travel and entertainment." Examples of accounts in which travel and entertainment expenses were found by team members were purchases, marketing, promotion, advertising, auto, and page allowances. In addition, one method of identifying the categories to which travel and entertainment expenses are posted is during the examination of the accounts payable accrual at year end. You would be looking for payments to credit card companies and travel agencies in particular. In

one case, the shareholder was traveling to Rome on personal business and the corporation was paying all of the expenses. The expenses for this trip were not included in the travel and entertainment accounts and not mentioned during the initial interview. The only way the examiner became aware of it was through the analysis of the year end accounts payable accrual.

4. Scan Canceled Checks and Cash Disbursements. Scan the canceled checks and cash disbursements journal for payments on credit cards and travel agencies. One examiner located payments for a shareholder's personal trip to Jamaica during this check. As in the above example, the amounts paid were not included in the travel and entertainment accounts.

**Sample Letter - AQMD**

Internal Revenue Service  
District Director Department of the Treasury

300 North Los Angeles Street  
Room 4012  
Los Angeles, CA 90012

Person to Contact: Examiner Name

Telephone Number:

Legal Division  
21865 East Copley Drive  
Diamond Bar, CA 91765

Refer Reply to:

Date:

Attn: Chief Prosecutor

RE: Public Records Search

We would appreciate you furnishing the information indicated below, for use in a federal tax matter by (enter response date).

You may, if you wish, reply on the back of this letter. A self-addressed envelope is enclosed for your convenience.

This request is made under the authority of IRC section 7602 of the Internal Revenue Code.

Thank you for your cooperation.

Sincerely,

Examiner name  
Examiner title

Enclosure: Envelope

===== Information Requested:

Type of fines or penalties imposed on the following corporation--

Company Name: (enter taxpayer's name)

Period Covering: (enter tax periods)

Description of Violation:

Date:

Amount:

Payment History: (Date of Payment, Check #, and Amount, if available)

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## GLOSSARY

**A.W.I.** --- Architectural Woodworking Institute

**Ad Slick** --- Manufacturer advertisements printed up with their product on it. These are very complete printings, therefore, all the retailer has to do is add their product number and price. This ad is printed in a periodical which is the only cost to the retailer.

**Back Charges** --- Damage done by installer.

**Builders Cabinets** --- Used in tract homes. They are large volume and low profit.

**Bullnose & Groove** --- Specific cut which rounds the edges of the wood.

**Buy-out** --- Fixtures shown on a design which must be purchased by taxpayer rather than produced. Taxpayer is directed on the plans and in the job specifications exactly what item to purchase - including the manufacturer, style, color, etc. These are items such as locks, lamps, etc.

**CFMA** --- California Furniture Manufacturing Association.

**CNC Router** --- Computerized woodworking machine which can perform the same operation many times over with precision. These machines are usually very expensive.

**C.O.M.** --- Customer's Own Material.

**Change order** --- An addition or deduction to a contract.

**Container** --- Used to describe a shipment of goods imported from overseas. Each container will have its own letter of credit number.

**Coping** --- A cut in the wood in the shape of a dove tail which allows two pieces to fit together at the corner without nails or glue. Usually better made furniture.

**Chargeback** --- Underpayment of the invoice due to incorrect billing.

**Cooperative Advertising** --- Manufacturer will pay up to a specific dollar amount or percent of net purchases for advertising done by the retailer which is related to the company's product.

**Custom Mill Work** --- Shop which manufactures to order and exact specifications. No finished inventory on site which is not pre-sold.

**Defective Allowance** --- Allowance deducted by a retailer to account for anticipated damages. Since the product manufactured is of such small dollar value, the cost to return it from the retailer to the manufacturer would cost more than the product itself. Therefore, the retailer will specify an allowance based on the defective pieces found. This percent will come off the top of the manufacturers invoice (that is, \$100,000 invoice, defective allowance of 3 percent, the retailer will remit \$97,000).

**Dove Tail** --- See Coping.

**Dowel Construction** --- This is a form of assembling furniture. This is the heart and sole of RTA. Eases assembly process for the customer. Very few tools are needed, usually just a screwdriver and a hammer.

**Edgebander** --- Applies a veneer stripe to the edge of the wood. Usually, less expensive wood.

**Fiber Board** --- Wood pieces/saw dust compressed with glues/resins to form a sheet of material  
Not a very expensive product.

**Flitch or Book Match** --- Log veneer. Veneer that is on top of each other. This provides a good matching of the grains.

**Framing** --- Attaching arm/leg pieces to sofas by inserting pegs on the arm/leg into the sofa dowel holes.

**Guaranteed Sale** --- It is a form of a consignment sale. Many of the large retailers (Walmart, Price Club) will use this in their agreement. If the product does not move, the manufacturer must purchase it back.

**Hardwood** --- Oaks, alder, mahogany, walnut, cherry.

**Hog** --- Machinery which grinds wood scrapes into sawdust.

**Knock Down (KD)** --- Furniture which needs assembly by the customer. Cuts down on cost to the customer because the retailer is able to have more delivered at the same price and the cost to assemble is eliminated.

**Landed Costs** --- Costs incurred to import goods from overseas. This will include Customs processing fees, insurance costs, letter of credit charges.

**Mailers** --- See Ad Slick.

**Millworkers** --- Cabinet makers.

**Module Cabinets** --- Standard size made at factory. Need filler pieces to complete the installation process. These usually can be purchased at the local hardware store (Home Depot & Home Base).

**Mouldings** --- Separate pieces of wood shaped into special designs and attached to the main cabinet or furniture thus giving it a certain look or quality.

**N.T.S.** -- Not to scale.

**Open Stock** --- Buy anything you want. If you need one night stand you could buy just one night stand.

**Paint Grade** --- Particle board/fiber board. Cannot be stained.

**Papered** --- Film or paper attached to fiberboard or press wood to give it an authentic wood appearance.

**Particle Board** -- Same as fiber board.

**Pin Router** --- Cuts the tongue and groove of the dove tail.

**Planer** -- Sands the surfaces for the top and sides of the desk, wall unit, credenza, etc.

**Plywood** --- Thin sheets of wood layered and glued to form a very strong sheet of wood which does not warp. Sheets come in multiple thicknesses.

**Pre-milled** --- Lumber pre-shaped by the mill. Manufacturer only has to assemble.

**Pressboard** --- Same as fiber board.

**Primary Contractors** --- Makes contact with the individual who will perform the work.

**Progress Draw Job** --- Deposits up front, then as the cost increases the taxpayer asks for another draw. Percentage of completion method.

**Railroad** --- Horizontal use of fabric (length) for the back of the sofa.

**Ready-to-Assemble (RTA)** --- Same as knock down.

**Remodel Laws** --- In CA when a primary contractor is performing every aspect of the remodel (manufacture and install), they are only allowed to collect a 10 percent deposit up front. Once the job is finished, the primary contractor can collect the balance owed. This only applies to individuals who are having remodeling done. This law does not apply if it's a manufacture only, no installation. If primary contractor collects more than 10 percent up front, the individual who is having remodeling done can bring a lawsuit so they do not have to pay the balance owed.

**Retention** --- Amount retained by the developer until the entire contract is completed. Usually, 10 percent of the contract.

**Rip** --- Boards cut with the grain of the wood into widths required for the manufacturing process.

**Rolling Stock** --- Work-in-process.

**SCAQMD** --- South Coast Air Quality Management District. Regulatory agency in Southern California.

**Sales Tax on Cabinets in CA** --- Module cabinets - sales tax on the whole (finished) cabinet. It will include all the materials, labor, & overhead. Custom cabinets - sales tax on materials purchased by the manufacturer only. No sales tax on the final cost, which would include labor and overhead. This is allowed if the cabinets become a part of the real property.

**Shop Drawings** --- Detailed blueprints showing dimensions and layout of job (vertical drawings).

**Siematic Kitchens** --- German cabinet brand, module cabinets

**Small Bone** --- English cabinets, pure custom and very expensive.

**Softwood** --- Pine, fir.

**Springing** --- Attaching springs to sofas.

**Subassembly** --- Component parts for frames, that is, arms, backs, seats which are manufactured by the company.

**Suite** --- Complete bedroom set - bed, two night stands, dresser and mirror. The chest is an option. When purchasing, you have to purchase all five pieces.

**Take-off**--- Materials/fixtures list showing number of items required per the specification. Taxpayer prices based on specific requirements and costs out each line item for use in the bid package.

**Trim** --- Generic term to describe attachments to main body of furniture such as doors, windows, mirrors, mouldings, etc.

**V.O.C.** --- Volatile Organic Compounds - chemicals regulated by the SCAQMD which are measured in grams of VOC/liter and pounds/gallon of applied material.

**Veneer** --- Thin strips/sheets of wood or plastic glued to plywood or particle/fiber board. Gives a more expensive look at a cheaper price. Many exotic woods will be veneered because of the cost or availability.

**Vertical** --- Not railroaded; use width of fabric versus length for back of the sofa. Requires more fabric.

**W.I.C.** --- Woodworking Institute of CA.

**Wings** --- Prefabricated arms for sofa & chairs.

**Wood Welder** --- Glues mouldings to desk.